Annual Review of Federal Securities Regulation

By the Subcommittee on Annual Review, Committee on Federal Regulation of Securities, ABA Business Law Section[*]

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Introduction

This Annual Review ("Review") was prepared by the Subcommittee on Annual Review of the Committee on Federal Regulation of Securities of the ABA Business

Law Section. The Review covers significant developments in federal securities law and regulation during 2020. The Review is divided into three sections: regulatory actions, accounting statements, and caselaw developments.

The Review is written from the perspective of practitioners in the fields of corporate and securities law. This results in an emphasis on significant developments under the federal securities laws relating to companies, shareholders, and their respective counsel. Our discussion is limited to those developments that are of greatest interest to a wide range of practitioners and addresses only final rules.

During 2020, the U.S. Securities and Exchange Commission (the "Commission"), together with the other agencies with oversight authority, adopted significant amendments to the Volcker Rule. The Commission also proceeded with the effectiveness, despite the Coronavirus pandemic, of the heightened standard of care for broker-dealers through Regulation Best Interest.

However, during 2020, the Commission's attention was focused principally on completing a number of amendments to the disclosure requirements arising pursuant to Regulation S-K and Regulation S-X that form part of the Commission's ongoing Disclosure Effectiveness initiative, which is intended to promote capital formation without sacrificing investor protection. In addition, during 2020, the Commission also focused on a number of proposed and final amendments to its rules relating to the framework governing exempt securities offerings.

Generally, the Review does not discuss proposed regulations or rules that are narrowly focused. For example, the Review generally does not address regulation of over-the-counter derivatives, hedge fund and other private fund related rulemaking, or rulemaking related to registered investment companies, registered investment advisers, registered broker-dealers, or municipal advisors. Cases are chosen for both their legal concept as well as factual background. While the Subcommittee tries to avoid making editorial comments regarding regulations, rules, or cases, we have attempted to provide a practical analysis of the impact of the developments in the law and regulations on the day-to-day practice of securities lawyers.

Regulatory Developments 2020

A. Commission's Amended Requirements for Registered Debt Issued or Guaranteed by Subsidiaries

The Commission has adopted final rules[1] that make it easier for a registrant to qualify for an exception to the requirement to file separate audited financial statements of a subsidiary issuer or guarantor of debt securities sold in a registered offering. The amended rules also streamline the disclosures a registrant must provide when it omits subsidiary financial statements, and the amended rules allow some companies to stop providing the disclosures earlier than under the legacy rules.

The changes will be most significant for registrants that have been (1) filing separate audited financial statements of subsidiary issuers or guarantors, but now qualify to provide summarized financial information and narrative disclosures instead or (2) providing condensed consolidating financial information, but now qualify under one of four safe harbors to provide only narrative disclosures instead of financial disclosures.

The Commission also amended the disclosure requirements when securities of an affiliate of the issuer are pledged as collateral for registered securities.

1. Eligibility Criteria to Omit Separate Audited Financial Statements

Like the legacy rules, amended Rule 3-10 allows companies to provide abbreviated disclosures in lieu of separate audited financial statements of subsidiary issuers and guarantors in certain cases.

The amended rules expand the legacy exceptions by focusing on the parent's role in the offering. That is, the rules now allow companies to provide abbreviated disclosures in lieu of separate audited financial statements of subsidiary issuers and guarantors if the parent company is (1) an issuer or co-issuer (jointly and severally) or (2) the full and unconditional guarantor of the registered securities of a consolidated subsidiary issuer.[2]

To be a "full and unconditional" guarantor, the parent company must be obligated by the guarantee to make a scheduled payment immediately upon the

1. Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities, Release No. 33-10762, 85 Fed. Reg. 21940 (Apr. 20, 2020) (to be codified at 17 C.F.R. pts. 210, 229, 230, 239, 240 & 249).

2. *Id.* at 21944.

subsidiary issuer's failure to do so. Further, the holders of the guaranteed debt securities must have immediate legal recourse against the parent guarantor for its failure to pay.

In addition to the above criteria, the following conditions must be met in order to omit the separate subsidiary issuer and guarantor audited financial statements:

- The consolidated audited financial statements of the parent company have been filed.
- The subsidiary issuer/guarantor is consolidated in the parent company's financial statements. (The subsidiary is no longer required to be 100 percent owned by the parent.)
- The guaranteed security is debt or debt-like.

The substance, rather than the form, of a security determines whether it is debt or debt-like. This condition is met when there is a contractual obligation to pay a fixed sum at a fixed time and, when the payment obligation is cumulative, a set amount of interest is to be paid. The Commission did not intend for "set amount of interest" to mean a fixed amount. That is, floating and adjustable rate securities and indexed securities can be debt-like, provided the payment obligation is set in the debt instrument and can be determined from objective indices or based on other factors that are outside the issuer's control.

2. Materiality

The amended rules include a provision that allows a registrant to omit any of the specified disclosures if they are not material. Additionally, the rules list four safe-harbor fact patterns that allow a company to omit financial information and provide only narrative disclosures.[3]

The amended rules also include a provision that requires the registrant to provide incremental disclosure about subsidiary guarantors (but not subsidiary issuers) beyond what is specified based on whether the registrant deems that information material to an evaluation of the sufficiency of the guarantee.[4]

3. Narrative Disclosures

Once the registrant determines it has met the eligibility criteria in amended Rule 3-10 to omit the separate audited financial statements of its subsidiary issuers and guarantors, it must comply with the disclosure requirements in Rule 13-01 and Exhibit 22 of Item 601 of Regulation S-K. These include requirements to make narrative disclosures about the issuers and guarantors, the terms and

3. *Id.* at 21982.
4. *Id.* at 21958.

conditions of the guarantees, and the rights and obligations of the issuers and guarantors.

The amended rules draw a distinction between the "description" and the "identification" of the issuers and guarantors of the debt securities.[5] A registrant must provide a description of the issuer and the guarantor(s) (collectively, the obligor group) in its Rule 13-01 disclosure and supplement this with an identification of the legal entities included in the obligor group in Exhibit 22 to its periodic reports and any registration statement related to an offering of guaranteed debt.

Exhibit 22, which may not be omitted based on any materiality assessment, must identify the debt securities, the parent company, each subsidiary in the obligor group, and whether the entity is an issuer, co-issuer, or guarantor. Exhibit 22 does not need to list an entity more than once if its role is clearly indicated. A hyperlink to an exhibit in an earlier filing is permitted if that exhibit remains accurate.

4. Terms and Conditions of Guarantees

Registrants are required to describe the terms and conditions of the guarantees.[6] The Commission said in the adopting release that these disclosures should address any limitations and conditions of a subsidiary's guarantee, whether it is joint and several with other guarantees, and any release provisions. The narrative disclosures are also required to include descriptions of:

- how payments to holders of the guaranteed securities may be affected by the composition of and relationships among the members of the obligor group and subsidiaries that are not part of the obligor group; and
- any other factors that may affect the guarantor's payments to holders.

5. Financial Disclosures

As mentioned above, the financial disclosures required by Rule 13-01 only need to be provided if they are material. To help a registrant evaluate whether it can omit financial disclosures, the Commission identified four fact patterns in which the financial information may always be omitted. Before preparing the financial disclosures specified by Rule 13-01, a registrant should first determine whether its facts match one of the safe harbors identified by the Commission. If one of the safe harbors applies and the financial information is omitted, the registrant must identify the fact pattern and provide the narrative disclosures.

The Commission acknowledged there could be other situations in which financial information may be omitted, based on the registrant's principles-based materiality assessment that is tailored to its relevant facts and circumstances. When one of the four safe-harbor fact patterns is not applicable, companies

5. *Id.* at 21955.
6. *Id.* at 21954.

that omit financial disclosures on the basis of immateriality would not be required to explain why they believe it is not material.

6. Summarized Financial Information

Registrants are required to disclose summarized financial information ("SFI"), as defined under Rule 1-02(bb) of Regulation S-X, of the obligor group.[7] The obligor group consists of all entities that have co-issued or guaranteed the registered debt security. At a minimum, SFI must include the following balance sheet and income statement line items, if applicable:

- current assets, noncurrent assets, current liabilities, noncurrent liabilities, and, when applicable, redeemable preferred stock and noncontrolling interests; or
- net sales or gross revenues, gross profit, income/loss from continuing operations, net income/loss, and net income/loss attributable to the group.

In a change from the legacy rules, the abbreviated financial information is not required to include cash flow information because the Commission believes investors should focus on the registrant's consolidated cash flow information.

Rule 13-01(a)(4)(vi) outlines four cases in which the registrant may provide only qualitative disclosure about the material terms of the registered debt and omit any SFI.

7. Combined Presentation

Information about subsidiary issuers and guarantors may be combined with the parent company into a single column of SFI for the obligor group, unless further disaggregation is required (see discussion below). SFI for the obligor group must be presented eliminating intercompany transactions and resulting balances among the entities in the obligor group. Intercompany balances and transactions between the obligor group and non-obligors must be presented as separate line items in the SFI. In addition, transactions and balances with other related parties outside the consolidated entity must also be presented separately.

8. Disaggregation of the Obligor Group's SFI

When the required narrative information about the terms and conditions of the guarantees applies to one or more, but not all, issuers and guarantors, separate SFI for those entities may need to be presented.[8] For example, separate SFI may be required due to differing limitations on subsidiary guarantees or different holders of NCIs.

The Commission said that a registrant should consider materiality and exercise judgment when assessing whether the obligor group's SFI must be

7. *Id.* at 21943.
8. *Id.* at 21986.

disaggregated. The registrant should consider both quantitative factors, such as the financial significance of the potentially disaggregated issuers and guarantors, and qualitative factors, such as the facts and circumstances that apply to each entity. If disaggregation is required but the separate SFI of the affected guarantors can be easily explained and understood, narrative disclosure would be sufficient.[9] However, the Commission said it expects narrative disclosure to be sufficient in lieu of disaggregated SFI only in limited circumstances, such as when the affected guarantors constitute a similar percentage of each line item in the SFI.

Additional line items may be required in the SFI if they would be material to an evaluation of the sufficiency of the guarantee. The Commission provided an example in which substantially all of the obligor group's noncurrent assets consist of goodwill. If the registrant in this example concludes that the disclosure would be material, it should present goodwill as a separate line item in the SFI. SFI must be accompanied by a note that "briefly describes" its basis of presentation. The note should address the mechanics of combination and, if applicable, the treatment of related party items and disaggregated entities.

The amended rules require a registrant to provide the balance sheet SFI as of the end of its most recent fiscal year presented and interim period (if interim financial statements are included in the filing).[10]

Income statement SFI is only required for the registrant's most recent fiscal year in annual reports. In quarterly reports, income statement SFI is only required for the year-to-date ("YTD") period. In a registration statement related to an offering of guaranteed securities, income statement SFI is only required for the most recent annual period presented and the YTD interim period if interim financial statements are required in the registration statement. This is a change from the legacy rules that previously required financial disclosures for all periods in which a registrant presents its financial statements in a filing.

9. Location of Disclosures

The Commission provided registrants with the flexibility to select the location of the disclosures.[11] As a result, a registrant can provide the disclosures outside of its financial statements in all cases. This is a change from the legacy rules that required the disclosures to be included as a footnote to the registrant's consolidated financial statements. A registrant can elect to provide the disclosures in its financial statement footnotes or it can provide them in Management's Discussion and Analysis ("MD&A"). The disclosures can also be placed immediately after risk factors or in a prospectus immediately after pricing information.

A registrant that elects to present the information in its annual financial statements must include the information in an audited footnote. Information placed outside of the annual financial statements does not need to be audited. While disclosures presented outside the registrant's financial statements would not

9. *Id.*
10. *Id.* at 21987.
11. *Id.* at 21976.

be subject to its internal control over financial reporting, they would be subject to its disclosure controls and procedures and management's certifications.

10. Recently Acquired Subsidiary Issuers or Guarantors

The amendments eliminate the legacy requirement for a registration statement to provide separate pre-acquisition audited financial statements for a recently acquired subsidiary issuer or guarantor. However, disclosure of pre-acquisition SFI for these entities may be required in a registration statement for the offer and sale of guaranteed debt securities. Pre-acquisition SFI is required when a subsidiary issuer or guarantor is acquired after the date of the most recent annual or interim balance sheet in the registration statement and it is a significant acquired business as defined by Regulation S-X.

The Commission leveraged its existing rules by requiring significance to be measured using Rule 3-05 of Regulation S-X. Therefore, pre-acquisition SFI disclosures would generally be required only when the registrant must provide Rule 3-05 financial statements of the acquired business.[12]

11. Suspending the Disclosure Obligations

A subsidiary issuer or guarantor that does not qualify for an exception to filing its separate audited financial statements must continue filing until the reporting obligation is suspended.[13] The reporting obligation can only be suspended if the debt securities are not listed on a national exchange. If that condition is met, a subsidiary can suspend its reporting obligation relying on section 15(d)(1) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), if, on the first day of any fiscal year other than the fiscal year in which the Securities Act of 1933, as amended (the "Securities Act"), registration statement related to the debt securities became effective, there are fewer than 300 record holders (or 1,200 record holders in the case of a bank, savings and loan, or bank holding company) of the class of debt securities. The reporting obligation can also be suspended at any time during a fiscal year if the conditions in Exchange Act Rule 12h-3[14] are met.[15] Except as explained below, the amended rules did not change the process for suspending these reporting obligations.

12. *Id.* at 21942.

13. *Id.* at 21963.

14. Rule 12h-3 provides that the duty to file reports under section 15(d) for a class of securities is suspended immediately upon the filing of a certification on Form 15, provided that the issuer has fewer than 300 holders of record, fewer than 500 holders of record where the issuer's total assets have not exceeded $10 million on the last day of each of the preceding three years, or, in the case of a bank, a savings and loan holding company, or a bank holding company, 1,200 holders of record; the issuer has filed its section 13(a) reports for the most recent three completed fiscal years and for the portion of the year immediately preceding the date of filing the Form 15 or the period since the issuer became subject to the reporting obligation; and a registration statement has not become effective or was required to be updated pursuant to Exchange Act section 10(a)(3) during the fiscal year.

15. Alternatively, foreign private issuers ("FPIs") are permitted to terminate Exchange Act reporting pursuant to the requirements of Exchange Act Rule 12h-6.

The amended rules continue to exempt a subsidiary issuer or guarantor from filing separate audited financial statements under Exchange Act Rule 12h-5 if it qualifies for an exception and the registrant provides the required disclosures. However, the amended rules no longer require a registrant to provide the Rule 13-01 disclosures as long as the debt securities are outstanding. A registrant can cease providing these disclosures once the subsidiary's reporting obligations have been suspended under the Exchange Act. The Commission noted that issuers and investors are free to negotiate contractual terms that require ongoing disclosures.

12. Affiliates Whose Securities Are Pledged as Collateral

Today, it is rare for a registrant that pledges the securities of an affiliate as collateral for registered securities to be required by Rule 3-16 to provide separate audited financial statements of that affiliate. This is because the securities typically include a provision that removes the collateral upon triggering the Commission requirement to provide separate financial statements.

To encourage registrants to offer registered securities without these collateral reductions that can disadvantage investors, the Commission replaced the disclosure requirements of Rule 3-16 with new Rule 13-02, which requires disclosures about such affiliates similar to those about subsidiary issuers and guarantors.[16]

The disclosures are required if they are material. This replaces the 20 percent threshold in legacy Rule 3-16, which required separate audited financial statements for the entity whose securities function as collateral, if the value of the collateral exceeds 20 percent of the fair value (or principal amount, if it is higher) of the registered notes.

Rule 13-02 requires certain narrative disclosures, including descriptions of the securities pledged as collateral, each affiliate whose securities are pledged, the terms and conditions of the collateral arrangement, the events or circumstances that would require delivery of the collateral, and whether a trading market exists for the pledged securities.

SFI of the affiliates is also required under Rule 13-02, if material. Unlike the SFI for the obligor group for guaranteed securities, the financial information of all subsidiaries consolidated by an affiliate would be included in the SFI even if those subsidiaries' securities are not pledged as collateral. When there are multiple affiliates whose securities have been pledged as collateral, disaggregation of the SFI may be required, if disclosures about the items addressed in the narrative disclosures apply to one or more, but not all, of the affiliates.

In the rare cases when an affiliate whose securities have been pledged as collateral is not a consolidated subsidiary, the registrant must provide any additional financial and narrative information material for investors to evaluate the

16. Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities, *supra* note 1, at 21968.

pledge; the information must be sufficient so that it is not misleading and might include separate financial statements of the unconsolidated affiliate.

13. Effective Date and Transition

The amended rules became effective January 4, 2021. Registrants may apply them to new registration statements and periodic reports on Forms 10-Q and 10-K.[17,18] Registrants must comply with the amended rules in their Exchange Act reports for fiscal periods ending after the effective date or in periodic reports for periods ending after the effective date of a registration statement in which they applied the amended rules early. The amended rules about collateralized debt securities apply to existing debt securities that are not structured to release the collateral if the Rule 3-16 disclosure requirements are triggered and to any new collateralized debt securities issued on or after the compliance date. The legacy rules will generally continue to apply to existing collateralized debt securities that are structured to release the collateral if the Rule 3-16 requirements are triggered.

B. Securities Offering Reform for Closed-End Investment Companies

When the Commission had initially adopted Securities Offering Reform[19] in 2005, it targeted operating companies and expressly excluded investment companies, including registered closed-end funds ("CEFs"), from the scope of such reforms. On April 8, 2020, some fifteen years later, the Commission finally adopted certain rule and form amendments expanding securities offering reform to CEFs by way of the provisions of the Small Business Credit Availability Act and the Economic Growth, Regulatory Relief, and Consumer Protection Act relating to business development companies and other registered closed-end funds (the "CEF Modernization Amendments").[20] Broadly, the CEF Modernization Amendments relate to (1) the registration process;[21] (2) Well-Known Seasoned Issuer status;[22] (3) automatic or immediate effectiveness for certain filings of

17. *Id.* at 21981.

18. The amended rules also apply to FPIs, which are directed to the new rules in the relevant filing forms. The Commission also eliminated the legacy requirement for a parent company that is an FPI to reconcile the financial disclosures to U.S. GAAP when its financial statements are not prepared under U.S. GAAP or IFRS IASB. Canadian parent companies that are eligible to utilize the multijurisdictional disclosure system ("MJDS") are not affected by the amended rules and should provide disclosures in accordance with applicable Canadian disclosure standards.

19. Securities Offering Reform, Release Nos. 8591, 34-52056; IC-26993; FR-75 (July 19, 2005) (to be codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249 & 274), https://www.sec.gov/rules/final/33-8591.pdf.

20. Securities Offering Reform for Closed-End Investment Companies, Release Nos. 33-10771, 34-88606; IC-33836; File No. S7-03-19 (to be codified at 17 C.F.R. pts. 229, 230, 232, 239, 240, 243, 249, 270 & 274), https://www.sec.gov/rules/final/2020/33-10771.pdf [hereinafter SEC Offering Reform for Closed-End Fund Release].

21. *Id.* at 18.

22. *Id.* at 39.

CEFs;[23] (4) final prospectus delivery requirements;[24] (5) offering and other communication reforms;[25] (6) registration fee payment methods for interval funds;[26] and (7) management's discussion of fund performance and other disclosure and reporting issues.[27]

1. Registration Process

The CEF Modernization Amendments allow CEFs to use the more flexible registration processes available to operating companies, which effectively allow CEFs to offer and sell securities "off the shelf" in a more efficient manner.[28] Previously, CEFs were theoretically able to conduct shelf offerings under Rule 415(a)(1)(x) provided that they meet the eligibility criteria for Form S-3.[29] However, no short form registration statement (analogous to Form S-3 for operating companies) existed with respect to CEFs, and, as such, CEFs were required to conduct such shelf offerings on the full Form N-2. Additionally, prior to the CEF Modernization Amendments, "forward incorporation"[30] was not permitted for CEFs. The practical effect of this is that before the CEF Modernization Amendments a CEF would be required to assure the inclusion of all required information in any "off the shelf" offering—including current financial information at the moment the registration statement was declared effective—which increased the cost and time needed to undertake such an offering. This resulted in the issuer being required to make subsequent post-effective amendments each time future updating information was required. The issuer then had to work with the Commission staff to get the post-effective amendment declared effective before use, which added additional burdens for the issuer with limited gains in terms of investor protection compared to the forward incorporation of certain information that was available to operating companies.

In response to these concerns, the CEF Modernization Amendments permit a CEF to file a short-form Form N-2 under General Instruction A.2, which will function in much the same way as the short-form Registration Statement on Form S-3.[31] A CEF will generally be eligible to file such a short-form N-2 if (1) it has been registered under the Investment Company Act of 1940, as amended (the "Company Act") for at least twelve months immediately preceding the filing and has timely filed all reports required to be filed under section 30 of the Investment Company Act (including Forms N-CSR, N-CEN, and N-PORT) during such period and (2) for a primary offering, if the CEF has a public float of at least $75 million.[32]

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23. *Id.*
24. *Id.* at 53.
25. *Id.* at 61.
26. *Id.* at 73.
27. *Id.* at 76.
28. *Id.* at 21.
29. 17 C.F.R. § 230.415 (2021).
30. "Forward incorporation" has traditionally been the means by which operating companies could incorporate to-be-filed disclosures in their Exchange Act reports into a prospectus.
31. *See* SEC Offering Reform for Closed-End Fund Release, *supra* note 20, at 23.
32. *Id.* at 24; *see also* General Instruction I.B of Form S-3.

Further, CEFs that qualify as Well-Known Seasoned Issuers ("WKSIs") will also have their short-form Form N-2s declared automatically effective.[33] The CEF Modernization Amendments also extend Securities Act Rule 430B to CEFs, which allows these funds to omit certain information from their base prospectus that can be added later through a prospectus supplement, as is currently permitted for operating companies.[34]

In addition, the CEF Modernization Amendments now permit CEFs to omit certain information that is unknown or not reasonably available to the issuer when the registration statement becomes effective.[35] In this case, the CEF will be required to include this information through a prospectus supplement prior to any offers or sales of securities under the registration statement.

2. Well-Known Seasoned Issuer Status

The CEF Modernization Amendments delete the exclusion of investment companies from the definition of a WKSI in Securities Act Rule 405.[36] To be a WKSI, a CEF issuer must meet the requirements to use Form S-3 (as if it were an operating company), meaning that the CEF has been a reporting company for, at least, the prior twelve consecutive calendar months and is current in its reports under section 30 of the Company Act. In addition, the CEF must have a public float of at least $700 million.[37]

3. Automatic or Immediate Effectiveness for Certain Filings by CEFs

The CEF Modernization Amendments further permit any registered CEF that conducts continuous offerings under Securities Act Rule 415(a)(1)(ix), such as continuously offered tender offer funds, to rely on Securities Act Rule 486.[38] Rule 486 allows interval funds to file post-effective amendments and certain registration statements that are either immediately effective or automatically effective sixty (60) days after filing.[39] These changes are designed to allow any fund that conducts a continuous or delayed offering to have an efficient means of bringing its disclosures current in the course of its offering.

4. Final Prospectus Delivery Requirements

Section 5(b)(2) of the Securities Act requires that registrants deliver to each investor in a registered offering a prospectus meeting the requirements of section

33. *Id.* at 11–12.
34. *Id.* at 20.
35. *Id.* at 35.
36. *See id.* at 39.
37. 17 C.F.R. § 230.405 (2021).
38. *See* SEC Offering Reform for Closed-End Fund Release, *supra* note 20, at 26.
39. 17 C.F.R. § 230.486 (2021).

10(a) of the Securities Act prior to, or at the time of, any sale.[40] Rule 172 permits issuers and broker-dealers to satisfy this delivery requirement if a "final prospectus" is, or will be, on file with the Commission within the relevant time period.[41] Previously, Rule 172 was not available to CEFs; however, the CEF Modernization Amendments now permit CEFs to rely on Rule 172.[42]

5. Offering and Other Communication Reforms

The CEF Modernization Amendments also provide relief to CEFs with respect to the "gun-jumping" provisions of the Securities Act, where this relief is currently afforded to operating companies.[43] The gun-jumping provisions restrict communications to the market (1) before an issuer files a registration statement, in all respects; (2) after an issuer files a registration statement, but before the registration statement becomes effective, to written offers made using a preliminary prospectus that meets the requirements of section 10 of the Securities Act; and (3) after a registration statement is declared effective, only if a statutory prospectus is provided at or prior to the time of communication.[44] The CEF Modernization Amendments permit certain CEFs to rely on Rule 134 to publish factual information about the issuer or the offering.[45] The CEF Modernization Amendments also permit these CEFs to rely on Rule 163A, which provides a thirty-day period prior to the filing of a registration statement, during which period the issuer may communicate without triggering gun-jumping implications.[46] CEFs will also be able to publish regularly released factual business information and forward-looking information at any time under Rules 168 and 169. Free writing prospectuses will also be available to CEFs under Rules 164 and 433.[47]

Additionally, the CEF Modernization Amendments permit broker-dealers participating in a registered offering to publish or distribute research reports about the investment company's other securities (i.e., if the issuance is an equity offering, the broker-dealer would be permitted to provide research reports about the issuer's fixed income securities).[48]

6. Management's Discussion of Fund Performance and Other Disclosure and Reporting Issues

Management's Discussion of Fund Performance ("MDFP") will also become a required disclosure item in the Form N-2 for all CEFs.[49] Prior to the adoption of the CEF Modernization Amendments, the MDFP disclosure was only required

40. *See* SEC Offering Reform for Closed-End Fund Release, *supra* note 20, at 59.
41. 17 C.F.R. § 230.172 (2021).
42. *See* SEC Offering Reform for Closed-End Fund Release, *supra* note 20, at 59.
43. *Id.* at 62.
44. *Id.*
45. *Id.* at 64.
46. 17 C.F.R. § 230.163A (2021).
47. *See* SEC Offering Reform for Closed-End Fund Release, *supra* note 20, at 61.
48. *Id.* at 67.
49. *See* New Instruction 4.g to Item 24 of amended Form N-2.

for mutual funds and ETFs in their annual report to shareholders.[50] The extension of the applicability of the MDFP to all CEFs mirrors the requirement of the MD&A disclosure that operating companies are currently required to provide. It is expected that CEFs will be required to discuss the factors that materially affected their performance during the most recently completed fiscal year, provide a graph comparing the initial and subsequent account values at the end of each of the most recently completed ten (10) fiscal years, and discuss the effect of providing a specified level of distributions to shareholders (if any) during the last fiscal year.[51]

The CEF Modernization Amendments also include certain changes to disclosure and reporting requirements designed to effectuate the above-described changes. These changes include the addition of new check boxes to the Form N-2 cover page relating to the effectiveness of the registration statement.[52] Moreover, Form N-2 will be amended to include information about the costs and expenses that the investor will bear directly or indirectly, which is intended to help the investor understand how the costs of investing in the CEF compare to other CEFs. The Form N-2 will also require the registrant to include information about the share price of the registrant's shares, as well as information about any premium or discount that the share price reflects to the registrant's net asset value.[53]

7. Effectiveness

The Amendments became effective on August 1, 2020; however, there are other certain provisions of the CEF Modernization Amendments—unrelated to CEFs—that will not become effective until August 1, 2021.

C. Commission Amends Financial Disclosure Requirements for Business Acquisitions and Dispositions

On May 21, 2020, the Commission adopted amendments to the financial statement disclosure requirements for business acquisitions and dispositions by Commission registrants that also apply to companies undertaking an initial public offering.[54] The amendments resulted from the Commission staff's ongoing evaluation of Regulation S-X and Regulation S-K as part of its Disclosure Effectiveness Initiative[55] and were proposed by the Commission in May 2019.[56]

50. *See* Item 27(b)(7) of Form N-1A. This requirement applies to registered open-end management investment companies other than money market funds.

51. *See* SEC Offering Reform for Closed-End Fund Release, *supra* note 20, at 95.

52. *See id.* at 80.

53. *See id.* at 92; *see also* Item 8.5 of amended Form N-2; new Instruction 4.h.(3) to Item 24 of amended Form N-2 (share price data).

54. Amendments to Financial Disclosures About Acquired and Disposed Businesses, Release No. 33-10786, 85 Fed. Reg. 54002 (Aug. 31, 2020) (to be codified at 17 C.F.R. pts. 210, 230, 239, 240, 249, 270 & 274).

55. *Id.* at 54003.

56. *See* Amendments to Financial Disclosures About Acquired and Disposed Businesses, Release No. 33-10635, 84 Fed. Reg. 24600 (proposed May 28, 2019) (to be codified at 17 C.F.R. pts. 210, 230, 239, 240, 249, 270 & 274).

When a Commission registrant acquires a significant business, other than a real estate operation, Rule 3-05 of Regulation S-X requires the filing of certain pre-acquisition financial statements of the business.[57] Whether an acquired business is significant is determined by applying the significance tests set forth in the definition of a "significant subsidiary" in Rule 1-02(w) of Regulation S-X, referred to as the Investment Test, the Asset Test, and the Income Test.[58] If any of these three tests exceeds the 20 percent significance threshold, then separate audited annual and unaudited interim pre-acquisition financial statements of the acquired business ("Rule 3-05 Financial Statements") must be filed.[59] The significance tests in Rule 1-02(w) also determine whether unaudited *pro forma* financial information is required under Article 11 of Regulation S-X for both acquisitions and dispositions of significant businesses.[60]

The significance tests and disclosure requirements related to an acquisition or disposition of a business in Regulation S-X are technical in many respects. Compliance can be costly and burdensome, and has historically resulted in a number of requests to the Commission staff for relief. The amendments discussed in this part are intended to facilitate more timely access to capital by registrants and reduce the complexity and costs of preparing these disclosures, while at the same time, improving financial information available to investors.[61]

The amendments became effective January 1, 2021. Voluntary compliance was permitted in advance of the effective date, provided that the amendments were applied in their entirety.[62]

1. Amendments to the Investment Test

Prior to the amendments, the Investment Test in Rule 1-02(w) assessed significance by comparing a registrant's[63] investments in and advances to an acquired or disposed business to the total assets of the registrant.[64] Because investments in and advances to a business generally equal the purchase or sale price of the business, which is a fair value measurement, the comparison of this fair value measurement to total assets measured at book value had the potential to distort the level of significance calculated by the Investment Test.[65] To address this discrepancy, the amendments to the Investment Test replace the book value of total

57. 85 Fed. Reg. at 54003.

58. *See id.* at 54004–05. Corresponding requirements for real estate operations are set forth in Rule 3-14 of Regulation S-X. *See* 17 C.F.R. § 210.3-14 (2021).

59. 85 Fed. Reg. at 54004–05. Similar requirements apply to smaller reporting companies under Article 8 of Regulation S-X, which also applies to issuers relying on Regulation A. The amendments incorporated references to Rule 3-05 into Rule 8-04 for purposes other than the form and contents of financial statements for smaller reporting companies, which will continue to be prepared in accordance with Rules 8-02 and 8-03 of Regulation S-X. *See id.* at 54018–19.

60. *See* 17 C.F.R. § 210.11-01(b) (2021).

61. 85 Fed. Reg. at 54042.

62. *Id.* at 54041–42.

63. For purposes of the significance tests in Rule 1-02(w), amounts for the registrant include amounts for the registrant's consolidated subsidiaries. *See* 17 C.F.R. § 210.1-02(w) (2021).

64. 85 Fed. Reg. at 54005.

65. *Id.*

assets in the denominator of the test with a fair value measurement equal to the aggregate market value of the registrant's outstanding voting and non-voting common equity, including equity held by affiliates.[66] To mitigate distortions in value due to swings in the market price of securities, the aggregate market value is averaged over the last five trading days of the registrant's most recently completed month that ends prior to the earlier of the announcement date or the agreement date of the acquisition or disposition.[67] For registrants without outstanding equity, and for application of the Investment Test outside of the context of an acquired or disposed business, the existing test using total assets as the denominator remains.[68]

The amendments also clarify that "investments in" the acquired or disposed business represent the consideration transferred, adjusted to exclude the registrant's and its subsidiaries' proportionate interest in the carrying value of assets transferred by the registrant to an acquired business that will remain with the combined entity after the acquisition.[69] This includes contingent consideration if contingent consideration is required to be recognized under U.S. GAAP or International Financial Reporting Standards issued by the International Accounting Standards Board ("IFRS-IASB"), as applicable.[70] However, if recognition at fair value is not required, investments in the acquired or disposed business must include all contingent consideration, except where the likelihood of payment is remote.[71] The amendments regarding contingent consideration are intended to prevent the under-identification of significant acquisitions where contingent consideration is involved.[72]

Finally, for combinations between entities or businesses under common control, significance under the Investment Test is met when either (1) the net book value of the acquired or disposed business exceeds 10 percent of the registrant's consolidated total assets or (2) the number of common shares exchanged, or to be exchanged, by the registrant exceeds 10 percent of its total common shares outstanding at the date the combination is initiated.[73]

2. Amendments to Income Test

The amendments to the Income Test added a new revenue component to the test.[74] Previously, the Income Test compared the net income of the acquired or disposed business to the net income of the registrant.[75] In situations where a company had low or no net income due to a non-recurring expense, the Income

66. *Id.* at 54006–07.
67. 17 C.F.R. § 210.1-02(w)(1)(i)(A)(3) (2021).
68. 85 Fed. Reg. at 54007.
69. 17 C.F.R. § 210.1-02(w)(1)(i)(A) (2021).
70. *Id.* § 210.1-02(w)(1)(i)(A)(1).
71. *Id.*
72. 85 Fed. Reg. at 54007.
73. 17 C.F.R. § 210.1-02(w)(1)(i)(B) (2021).
74. 85 Fed. Reg. at 54009.
75. *Id.* at 54008.

Test could result in filing Rule 3-05 Financial Statements even where the acquired business is not material to investors.[76] The new revenue component added to the Income Test is intended to reduce this result.[77]

The new revenue component of the Income Test compares a registrant's proportionate share of the acquired business' consolidated total revenues (after intercompany eliminations) to the consolidated total revenues of the registrant for the most recently completed fiscal year.[78] The revenue component will only apply if both the registrant and the acquired business have material revenue in each of the two most recently completed fiscal years.[79] If this standard is met, then Rule 3-05 Financial Statements will only be required if both the new revenue component and the net income component of the new Income Test are satisfied.[80]

3. Using *Pro Forma* Financial Statements to Measure Significance

Previously, Commission rules permitted the use of *pro forma,* rather than historical, financial information to make significance determinations where a registrant had made a significant acquisition after the last fiscal year and the acquired business' Rule 3-05 Financial Statements and related *pro forma* financial information had been filed on a Form 8-K.[81] However, comparable *pro forma* financial information relating to a significant business disposition could not be used, and the Form 8-K filing requirement meant that companies conducting an initial public offering could not use *pro forma* financial information relating to an acquisition or disposition to make significance determinations.[82] These limitations have resulted in inconsistent outcomes for registrants depending on the nature of the business transaction and the registration status of the registrant.

To address this, the amendments now allow registrants to measure significance using filed *pro forma* financial information for both significant acquisitions and dispositions subsequent to the last fiscal year.[83] The amendments include certain limitations regarding the adjustments that can be made to the *pro forma* financial statements for purposes of significance testing.[84] Further, the amendments provide that once a registrant uses *pro forma* financial information to measure significance, it must thereafter continue to use *pro forma* financial information to measure significance of acquired or disposed businesses until its next annual report on Form 10-K or Form 20-F.[85]

76. *Id.* at 54009.
77. *Id.*
78. 17 C.F.R. § 210.1-02(w)(1)(iii)(A)(2) (2021).
79. *Id.*
80. *Id.* § 210.1-02(w)(1)(iii).
81. 85 Fed. Reg. at 54021.
82. *Id.*
83. 17 C.F.R. § 210.11-01(b)(3) (2021).
84. *Id.*
85. *Id.* § 210.11-01(b)(3)(i)(B)(2).

4. Required Periods for Rule 3-05 Financial Statements

In addition to amending the significance tests used to determine when Rule 3-05 Financial Statements are required, the amendments changed the periods for which Rule 3-05 Financial Statements of an acquired business must be filed, other than in connection with a registration of securities to be offered to the security holders of the acquired business.[86] Previously, up to three years of Rule 3-05 Financial Statements were required when an acquired business was significant at the highest level.[87] The amended rules now require only up to two years of audited financial statements.[88] The following chart shows the new periods required for Rule 3-05 Financial Statements[89]:

Highest Level of Significance	**New Requirement**
Less than 20%	No financial statements required.
Greater than 20%, but less than 40%	One year of audited financial statements; unaudited financial statements for most recent interim period (corresponding prior-year interim period no longer required).
Greater than 40%	Two years of audited financial statements; unaudited financial statements for most recent interim period and corresponding prior-year period.

5. Abbreviated Rule 3-05 Financial Statements for Assets that Constitute a Business

When a company acquires assets that meet the definition of a "business" under Rule 11-01(d) of Regulation S-X, but the assets are not a separate entity, subdivision, or division of a business, Rule 3-05 Financial Statements for the acquired assets may be required even though the assets only make up part of a larger business.[90] This requirement can potentially be burdensome because the selling entity may not have maintained separate records necessary to prepare such financial statements.[91] Historically, registrants have frequently sought relief from the Commission's staff to ease the burden of preparing such financial statements.[92]

86. 85 Fed. Reg. at 54012. Rule 3-05(b)(1) of Regulation S-X sets forth the requirements in connection with a registration of securities to be offered to the security holders of the acquired business. 17 C.F.R. § 210.3-05(b)(1) (2021).
87. 85 Fed. Reg. at 54011.
88. 17 C.F.R. § 210.3-05 (2021).
89. *Id.* § 210.3-05(b)(2).
90. 85 Fed. Reg. at 54012.
91. *Id.*
92. *Id.*

The amendments added a new Rule 3-05(e), which allows the presentation of audited abbreviated financial statements for an acquired business where certain conditions are met.[93]

Where these qualifications are satisfied, the amendments permit the presentation of abbreviated financial statements consisting of a balance sheet reflecting the assets acquired and liabilities assumed, a statement of revenues and expenses which may exclude certain corporate overhead, interest, and income tax expenses, and notes that explain how the abbreviated financial statements were prepared.[94]

6. Omitting Rule 3-05 Financial Statements

Previously, Rule 3-05 Financial Statements could be omitted once the operating results of the acquired business had been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year, unless the Rule 3-05 Financial Statements had not previously been filed or the acquired business was of "major significance" to the registrant (e.g., significance exceeded 80 percent).[95] The amendments eliminated these limitations, such that Rule 3-05 Financial Statements for businesses that exceed 40 percent significance can be omitted once the operations of the acquired business have been included in the audited financial statements of the registrant for at least one year,[96] regardless of whether Rule 3-05 Financial Statements for the acquired business were ever filed or the level of significance for the transaction.[97] The adopting release did note, however, that registrants must still consider whether omitted Rule 3-05 Financial Statements are necessary to "make the required statements, in light of the circumstances under which they are made, not misleading" as required by Rule 4-01(a) of Regulation S-X.[98]

Further, the amendments allow registrants to omit pre-acquisition Rule 3-05 Financial Statements for acquired businesses that exceed 20 percent significance, but do not exceed 40 percent significance, once they are included in the registrant's audited post-acquisition results for at least nine months.[99] This change aligns the requirement for Rule 3-05 Financial Statements for acquired businesses below the 40 percent significance threshold with Rule 3-06 of Regulation S-X,[100] which permits filing Rule 3-05 Financial Statements covering a period of nine months to satisfy the requirement to provide annual financial statements under Rule 3-05.[101]

93. 17 C.F.R. § 210.3-05(e) (2021).
94. *Id.* § 210.3-05(e)(2).
95. 85 Fed. Reg. at 54020.
96. 17 C.F.R. § 210.3-05(b)(4)(iii) (2021).
97. 85 Fed. Reg. at 54020–21.
98. *Id.* at 54021 (quoting 17 C.F.R. § 210.4-01(a)).
99. 17 C.F.R. § 210.3-05(b)(4)(iii) (2021).
100. 85 Fed. Reg. at 54020–21.
101. 17 C.F.R. § 210.3-06 (2021).

7. Individually Insignificant Acquisitions

When a registrant acquires unrelated businesses after the date of the most recent audited balance sheet filed for the registrant that are not significant individually but together exceed 50 percent significance, Commission rules have historically required Rule 3-05 Financial Statements and related *pro forma* financial information be filed for a substantial majority of the acquired businesses.[102] This resulted in the filing of Rule 3-05 Financial Statements for individual businesses that were not material to the registrant.[103] The amendments dispense with the requirement to file the Rule 3-05 Financial Statements for acquired businesses whose individual significance does not exceed 20 percent.[104] The amendments clarify that "individually insignificant businesses" include not only acquisitions consummated after the registrant's audited balance sheet date whose significance does not exceed 20 percent, but also probable acquisitions whose significance does not exceed 50 percent and consummated acquisitions whose significance exceeds 20 percent, but does not exceed 50 percent, for which financial statements are not yet required because of the seventy-five-day filing period in Rule 3-05(b)(4) of Regulation S-X.[105]

In conjunction with this change, *pro forma* financial information depicting the aggregate effects in all material respects of individually insignificant businesses that together exceed 50 percent significance is still required.[106] Amendments to Rule 11-01(c) clarify that, where the aggregate impact of individually insignificant businesses is significant as determined by the revised rules, the exception that would otherwise permit the omission of *pro forma* financial information when separate financial statements of the acquired business are not included in the filing does not apply.[107]

8. *Pro Forma* Financial Statements

Pro forma financial information combines the historical financial statements of the registrant and an acquired business to reflect the impact of the acquisition on the registrant's financial statements.[108] The amendments raised the significance threshold for *pro forma* financial information related to dispositions from 10 percent to 20 percent, conforming to the filing requirement for Rule 3-05 Financial Statements for significant acquisitions.[109] The amendments also align the significance tests for disposed businesses with the aforementioned amendments to the significance tests for acquired businesses.[110] Additionally, the amendments simplified the adjustment criteria for preparing *pro forma*

102. 85 Fed. Reg. at 54022.
103. *Id.* at 54023.
104. *Id.*
105. 17 C.F.R. § 210.3-05(b) (2021).
106. *Id.* § 210.3-05(b)(2)(iv).
107. *Id.* § 210-11.01(c).
108. *See* 85 Fed. Reg. at 54029.
109. *Id.* at 54034.
110. *Id.*

financial information by creating two categories of mandatory adjustments: (1) adjustments that depict the required accounting for the transaction under U.S. GAAP or IFRS-IASB (referred to in Rule 11-02(a)(6)(i) as "Transaction Accounting Adjustments") and (2) adjustments necessary to reflect the operations and financial position of a registrant as an autonomous entity when the registrant was previously part of another entity (referred to in Rule 11-02(a)(6)(ii) as "Autonomous Entity Adjustments").[111] The amendments also permit a third category of adjustments that present reasonably estimable synergies and other transaction effects ("Management's Adjustments"), which a registrant may elect to present in the notes to the *pro forma* financial information.[112] To present Management's Adjustments in the *pro forma* financial information, the registrant must (1) have a reasonable basis for the adjustments, (2) limit the adjustments to the effects on the historical financial statements to the beginning of the fiscal year presented, and (3) reflect all Management's Adjustments that are, in the opinion of management, necessary to a fair statement of the *pro forma* financial information presented.[113] Management's Adjustments are presented in the notes to the *pro forma* financial information as reconciliations of *pro forma* net income from continuing operations attributable to the controlling interest, and the related *pro forma* earnings per share data, to such amounts after giving effect to Management's Adjustments.[114]

For *pro forma* financial information in or incorporated by reference into a registration statement, proxy statement, Regulation A offering statement, or Form 8-K, Management's Adjustments must be updated to the most recent practicable date prior to the effective date, mail date, qualified date, or filing date, as applicable, of the filing.[115] If Management's Adjustments will change the number of shares or potential common shares, the change must be reflected within Management's Adjustments in accordance with U.S. GAAP or IFRS-IASB, as applicable, as if the common stock, or potential common stock, were outstanding as of the beginning of the period presented.[116] The notes to the *pro forma* financial statements must disclose the basis for and the material limitations of each Management's Adjustment.[117]

Because Management's Adjustments may contain forward-looking information, the amendments clarify that forward-looking information supplied in connection with *pro forma* financial information is expressly covered by the safe-harbor provisions under Rule 175 of the Securities Act and under Rule 3b-6 of the Exchange Act.[118]

111. 17 C.F.R. § 210.11-02(a)(6) (2021).
112. *Id.* § 210.11-02(a)(7).
113. *Id.* § 210.11-02(a)(7)(i). This condition includes presenting any related dis-synergies when synergies are presented. *Id.* § 210.11-02(a)(7)(i)(B).
114. *Id.* § 210.11-02(a)(7)(ii)(A).
115. *Id.* § 210.11-02(a)(7)(ii)(B).
116. *Id.* § 210.11-02(a)(7)(ii)(C).
117. *Id.* § 210.11-02(a)(7)(ii)(D).
118. *Id.* at Instruction 1 to § 210.11-02(a)(7).

9. Clarifications About Timing and Terminology

The amendments include two changes to clarify timing for filing Rule 3-05 Financial Statements and *pro forma* financial information, as well as a number of general updates to the language in Rule 3-05 and Article 11 of Regulation S-X.[119]

With respect to timing, the amendments specify that Rule 3-05 Financial Statements are required if a business acquisition has occurred during the most recent fiscal year or subsequent interim period for which a balance sheet is required by Rule 3-01 of Regulation S-X, or if a business acquisition has occurred or is probable after the date that the most recent balance sheet has been filed.[120]

Further, the amendments provide that a registrant may continue to determine significance using amounts reported in its Form 10-K for the most recent fiscal year when the registrant filed its Form 10-K after the acquisition's consummation, but before the date the registrant is required to file financial statements of the acquired business on Form 8-K.[121] Form 8-K generally requires that Rule 3-05 Financial Statements and related *pro forma* information be filed within seventy-five days after the date a significant acquisition was consummated.[122]

10. Foreign Businesses

The amendments expand the application of IFRS-IASB to financial information provided under Rule 3-05 and Article 11 of Regulation S-X.[123] First, FPIs that prepare their financial statements in accordance with IFRS-IASB may reconcile financial statements of foreign acquisition targets that prepare their financial statements utilizing home country GAAP by using IFRS-IASB instead of U.S. GAAP as previously required.[124] Second, the amendments allow Rule 3-05 Financial Statements to be prepared in accordance with IFRS-IASB, without reconciliation to U.S. GAAP, if the acquired business would qualify as an FPI if it were a Commission registrant.[125] These amendments should help registrants avoid unnecessary costs, including one-time presentations of U.S. GAAP reconciling information, where such information would not be material to investors.[126]

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119. 85 Fed. Reg. at 54016–17.

120. 17 C.F.R. § 210.3-05(a) (2021).

121. *Id.* § 210.11-01(b)(3)(i)(C).

122. Item 9.01 of Form 8-K requires that the financial statements for a significant business acquisition and *pro forma* financial information for a significant business acquisition or disposition (including a real estate operation) be filed not later than seventy-one calendar days after the due date of the initial report on Form 8-K reporting the transaction under Item 2.01, which is due four business days after the consummation of the business acquisition or disposition. The result is that registrants have approximately seventy-five calendar days to file the any required financial statements and *pro forma* financial information.

123. *See* 85 Fed. Reg. at 54018.

124. 17 C.F.R. § 210.3-05(c) (2021).

125. *Id.* § 210.3-05(d).

126. 85 Fed. Reg. at 54018.

11. Real Estate Operations

Rule 3-14 of Regulation S-X contains filing requirements for financial statements of acquired real estate operations.[127] These requirements differ from Rule 3-05 filing requirements in recognition of the unique industry conditions that exist for real estate operations.[128] The amendments align Rule 3-14 with the amendments to Rule 3-05, where no unique industry considerations exist, while retaining the industry specific disclosure necessary for investors to make informed investment decisions.[129] These changes include eliminating a previous requirement to incorporate additional periods of financial statements for real estate operations acquired from related parties.[130] The amendments also defined the previously undefined term "real estate operation" as "a business that generates substantially all of its revenues through the leasing of real property,"[131] but indicated that this definition is not intended to change the substance of how the term has historically been applied.[132]

D. Commission Adopts Rules Amending Proxy Voting Advice Rules

The Commission has long wrestled with the issue of whether "proxy voting advice businesses" ("proxy advisers" or "proxy advisory firms")[133] should be regulated, and if so, how best to regulate activities conducted by such firms.[134] The question of whether proxy advisory firms should be regulated arises out of the increasing concentration of power and significant influence of proxy advisory firms.[135] On July 22, 2020, the Commission answered the question in the affirmative, voting to adopt amendments (the "Proxy Voting Advice Amendments") to the proxy rules relating to proxy voting advice.[136] The Proxy Voting Advice

127. *See* 17 C.F.R. § 210.3-14 (2021).

128. *See* 85 Fed. Reg. at 54024.

129. *Id.* at 54024–25.

130. *Id.* at 54025.

131. 17 C.F.R. § 210.3-14(a)(2)(i) (2021).

132. 85 Fed. Reg. at 54027.

133. Exemptions from the Proxy Rules for Proxy Voting Advice, Release No. 34-89372 (July 22, 2020) (to be codified at 17 C.F.R. pt. 240), https://www.sec.gov/rules/final/2020/34-89372.pdf [hereinafter Proxy Voting Adopting Release]. In the Proxy Voting Adopting Release, the Commission uses the term "proxy voting advice business" to define a person furnishing proxy voting advice as defined under the amendments to the federal proxy rules; we use "proxy voting advice business" and "proxy advisory firms" interchangeably.

134. Chairman Jay Clayton, *Public Statement Proxy Voting—Reaffirming and Modernizing the Core Principles of Fiduciary Duty and Transparency to Provide for Better Alignment of Interest Between Main Street Investors and the Market Professionals Who Invest and Vote on Their Behalf*, U.S. Sec. & Exchange Commission (July 22, 2020), https://www.sec.gov/biography/jay-clayton.

135. *See* Andrew Ackerman, *Commission Takes Action Aimed at Proxy Advisers for Shareholders*, Wall St. J. (Aug. 21, 2019), https://www.wsj.com/articles/sec-to-take-action-aimed-at-proxy-advisers-for-shareholders-11566399808 (stating that ISS and Glass Lewis have been cited as having a 97 percent share of the proxy advisory market).

136. Proxy Voting Adopting Release, *supra* note 133, at 6 n.7.

Amendments were adopted pursuant to broad authority.[137] Congress vested in the Commission authority to oversee the proxy solicitation process under the Exchange Act. The Proxy Voting Advice Amendments codify the Commission's longstanding interpretation that proxy voting advice recommendations and related materials provided by proxy advisers generally constitute a "solicitation"[138] under section 14 of the Exchange Act and such rules (the "federal proxy rules"),[139] and are therefore subject to antifraud provisions of Exchange Act Rule 14a-9.[140] In addition, the Proxy Voting Advice Amendments place additional conditions on proxy advisory firms that intend to continue relying on exemptions[141] from the information and filing requirements applicable to proxy solicitation materials.[142] The new conditions will require proxy advisers to provide disclosure regarding conflicts of interest;[143] to adopt and publicly disclose policies designed to ensure that their voting advice is made available to subject companies on a timely basis;[144] and to report any company responses regarding the voting advice to their clients.[145] The Proxy Voting Advice Amendments also provide two non-exclusive safe harbors designed to satisfy the conditions to the exemptions.[146] The Proxy Voting Advice Amendments are effective sixty days after publication in the Federal Register, but proxy advisers subject to the new rules will not be required to comply with the Rule 14a-2(b)(9) amendments until December 1, 2021. As a result, the 2022 annual proxy season will be the first for which the new process and disclosure requirements are mandatory. The transition period does not apply to the amendments to Rule 14a-1(*l*) and Rule 14a-9.[147]

The Commission has long held the view that the furnishing of proxy voting advice generally constitutes a "solicitation" governed by the Exchange Act's

137. *Id.* at 5 n.3; *see* Regulation of Communications Among Shareholders, Release No. 34-31326, 57 Fed. Reg. 48276, 48277 (Oct. 22, 1992) ("Underlying the adoption of Section 14(a) of the Exchange Act was a Congressional concern that the solicitation of proxy voting authority be conducted on a fair, honest and informed basis. Therefore, Congress granted the Commission the broad 'power to control the conditions under which proxies may be solicited' . . . .").

138. Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Release No. 34-86721 (Sept. 10, 2019) (to be codified at 17 C.F.R. pt. 241), https://www.sec.gov/rules/interp/2019/34-86721.pdf (stating that the Commission has taken the position since 2010 that proxy voting advice may be "solicitation" subject to regulation under section 14 of the Exchange Act).

139. Any reference to the Exchange Act, or any paragraph of the Exchange Act, references 15 U.S.C. § 78a, at which the Exchange Act is codified, and any reference to rules under the Exchange Act, or any paragraph of these rules, refers to 17 C.F.R. § 240, in which these rules are published.

140. 17 C.F.R. § 240.14a-9 (2021).

141. *Id.* § 240.14a-2.

142. *Id.*

143. *Id.*

144. *Id.*; *See* Proxy Voting Adopting Release, *supra* note 133; *see also* Proposing Release Exemptions from the Proxy Rules for Proxy Voting Advice, Release No. 34-87457, 84 Fed. Reg. 66518 (proposed Dec. 4, 2019).

145. 17 C.F.R. § 240.14a-2(b)(9)(ii)(A) (2021).

146. *Id.* § 240.14a-2(b)(9)(ii)(A)(2)(a).

147. *Id.* §§ 240.14a-1(*l*), 240.14a-9.

proxy rules.[148] The amendments codify this interpretation by amending Rule 14a-1(*l*) to make clear that the terms "solicit" and "solicitation" include any proxy voting advice that makes a recommendation to a shareholder as to its vote, consent, or authorization on a specific matter for which shareholder approval is solicited, and that the proxy voting advice is furnished by a person who markets its expertise as a provider of such advice, separately from other forms of investment advice,[149] and sells such advice for a fee.[150]

Proxy advisory firms have typically relied upon the exemptions in Rule 14a-2(b)(1) (exempting solicitations by persons who do not seek the power to act as proxy for a shareholder and do not have a substantial interest in the subject matter of the communication beyond their interest as a shareholder)[151] and Rule 14a-2(b)(3) (exempting proxy voting advice furnished by an advisor to any other person with whom the advisor has a business relationship)[152] to avoid the filing and information requirements generally required for solicitations under the federal proxy rules. The amendments impose new conditions,[153] contained in new subsection (9) of Rule 14a-2(b), that apply to persons furnishing proxy voting advice to continue to rely on the exemptions in Rules 14a-2(b)(1) and 14a-2(b)(3). The new rules do not apply to mergers and acquisitions (M&A) transactions and contested elections[154] or to proxy voting advice provided pursuant to custom policies.[155]

E. Commission Expands Definition of "Accredited Investor"

On August 26, 2020, the Commission adopted amendments (the "Accredited Investor Amendments") to the "accredited investor" definition found in Rule 501(a) and Rule 215.[156] The Accredited Investor Amendments, which took effect on December 8, 2020, expanded the definition, allowing for a larger class of investors to participate in securities offerings exempt from registration. The Commission has previously acknowledged that the significance of the exempt securities markets has increased in recent years, both in terms of the absolute amount raised in exempt offerings and relative to the public registered markets.[157]

The Commission has previously stated that the accredited investor definition is "intended to encompass those persons whose financial sophistication and

148. *See* Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release No. IA-5547 (July 22, 2020) (to be codified at 17 C.F.R. pt. 276), https://www.sec.gov/rules/policy/2020/ia-5547.pdf.

149. *See* Commission Interpretation Regarding Standards of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 Fed. Reg. 33669 (July 12, 2019).

150. Proxy Voting Adopting Release, *supra* note 133; 17 C.F.R. § 240.14a-1 (2021).

151. 17 C.F.R. § 240.14a-2(b)(1) (2021).

152. *Id.* § 240.14a-2 (b)(2).

153. *Id.* § 240.14a-2(b)(9).

154. *Id.* § 240.14a-2(b)(9)(vi); Proxy Voting Adopting Release, *supra* note 133, at 115.

155. 17 C.F.R. § 240.14a2(b)(9)(v) (2021); Proxy Voting Adopting Release, *supra* note 133, at 113.

156. Accredited Investor Definition, Release Nos. 33-10824; 34-89669, 85 Fed. Reg. 64234 (Oct. 9, 2020) [hereinafter Accredited Investor Definition].

157. *Id.* at 64235.

ability to sustain the risk of loss of investment or fend for themselves render the protections of the Securities Act's registration process unnecessary."[158] Prior to the adoption of the Accredited Investor Amendments, the accredited investor definition used only financial wherewithal—in the form of a certain level of income or net worth—as a proxy for financial sophistication.[159] In the release announcing the adoption of the final rules amending the accredited investor definition (the "Final Accredited Investor Release"), the Commission acknowledged that wealth is not the only indicator of a person's financial sophistication.[160] Accordingly, the Accredited Investor Amendments create new categories of individuals and entities that qualify as accredited investors irrespective of their financial condition, on the basis that such investors have objectively demonstrated the requisite ability to assess an investment opportunity.[161]

1. Rule Amendments for Individuals

a. Professional Certifications and Designations or Other Credentials

The Accredited Investor Amendments add to the category of accredited investors any natural person who holds, in good standing, one or more professional certifications, designations, and other credentials designated by the Commission (collectively, "credentials" and, each, a "credential").[162] Such qualifying credentials will not be delineated in Rule 501(a), but will instead be designated by the Commission pursuant to an order, so that the accredited investor definition does not require amendment each time a credential is added to the qualifying credentials list. In connection with the adoption of this amendment, the Commission designated[163] the Licensed General Securities Representative (Series 7), the Licensed Investment Adviser Representative (Series 65), and the Private Securities Offerings Representative (Series 82) as the initial qualifying credentials.[164]

158. *Id.*; *see* Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Release No. 33-6683, 52 Fed. Reg. 3015 (Jan. 30, 1987); *see also* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (ruling that the availability of the exemption under section 4(2) (now section 4(a)(2)) "should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

159. Accredited Investor Definition, *supra* note 156, at 64235.

160. *Id.*

161. *Id.*

162. *Id.* at 64241.

163. Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status, Release No. 33-10823, 85 Fed. Reg. 64234 (Oct. 9, 2020).

164. The Series 7 license qualifies a candidate "for the solicitation, purchase, and/or sale of all securities products, including corporate securities, municipal securities, municipal fund securities, options, direct participation programs, investment company products, and variable contracts." *See Series 7—General Securities Representative Exam, Permitted Activities*, FINRA, https://www.finra.org/registration-exams-ce/qualification-exams/series7 (last visited Apr. 19, 2021). The Series 65 exam is designed to qualify candidates as investment adviser representatives and covers topics that adviser representatives must understand in order to provide investment advice to retail advisory clients. *See Series 65 Study Guide, Overview*, NASAA, https://www.nasaa.org/exams/study-guides/series-65-study-guide (last visited Apr. 19, 2021). The Series 82 license qualifies candidates seeking to effect the sales

b. Knowledgeable Employees of Private Funds

The Accredited Investor Amendments also qualify "knowledgeable employees" of a private fund as accredited investors for investments in the fund.[165] The term "knowledgeable employee" has the same meaning that it has under Rule 3c-5(a)(4) of the Company Act.[166] This category is similar to the existing accredited investor category for directors, executive officers, or general partners of the issuer (or directors, executive officers, or general partners of a general partner of the issuer), which provides that any such person will be considered an accredited investor only with respect to investments in the issuer, unless such person qualifies as an accredited investor pursuant to another category.[167]

Under Rule 501(a)(8), a private fund with assets of $5 million or less qualifies as an accredited investor if all of the fund's equity owners are accredited investors.[168]

2. Rule Amendments for Entities

a. Registered Investment Advisers and Exempt Reporting Advisers

The Accredited Investor Amendments also added several accredited investor categories for entities. The first of these categories was for Commission- and state-registered investment advisers.[169] The Commission is also including exempt reporting advisers (at the Commission level) in the definition of accredited investor. The Commission noted that in order to qualify as an exempt reporting adviser under section 203(m) or section 203(*l*) of the Investment Advisers Act of 1940 (the "Advisers Act"), an adviser would otherwise be required to register as an investment adviser with the Commission and thereby meet the minimum asset thresholds triggering that requirement.[170]

of private securities offerings. *See Series 82—Private Securities Offerings Representative Exam*, FINRA, https://www.finra.org/registration-exams-ce/qualification-exams/series82 (last visited Apr. 19, 2021). *See also* Accredited Investor Definition, *supra* note 156, at 64242.

165. Accredited Investor Definition, *supra* note 156, at 64244.

166. *See* 17 C.F.R. § 230.501(a)(11) (1982).

167. Accredited Investor Definition, *supra* note 156, at 64244.

168. *Id.* A private fund may qualify as an accredited investor if it holds total assets in excess of $5 million and is a corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered. A private fund may also be able to qualify as an accredited investor if it is a trust with total assets in excess of $5 million that was not formed for the specific purpose of acquiring the securities offered and the purchase is directed by a sophisticated person.

169. 17 C.F.R. § 230.501(a)(1) (2021).

170. *Id.* Advisers must apply for registration with the Commission if their regulatory assets under management are at least $110 million or if they have regulatory assets under management of at least $25 million but less than $100 million and meet one of the requirements to be classified as a "mid-sized adviser." *See* Investment Advisors Act of 1940, 17 C.F.R. § 275.203A-1(a)(2) (2021); *see also* SEC Form ADV: Instructions for Part 1A, 2.B. This is available at https://www.sec.gov/about/forms/formadv-instructions.pdfhttps://www.sec.gov/about/forms/formadv-instructions.pdf.

b. Rural Business Investment Companies

The amended accredited investor definition includes rural business investment companies ("RBIC"). A company becomes an RBIC by applying for an RBIC license with the U.S. Department of Agriculture ("USDA").[171] USDA will award an RBIC license only to those companies that (1) are newly formed for-profit entities or newly formed for-profit subsidiaries of such an entity, (2) have a management team with experience in community development financing or relevant venture capital financing, and (3) invest in enterprises that will create wealth and job opportunities in rural areas, with an emphasis on smaller enterprises.[172]

c. Limited Liability Companies

Prior to the adoption of the Accredited Investor Amendments, Rule 501(a)(3) set forth the following types of entities that qualify for accredited investor status if they have total assets in excess of $5 million and were not formed for the specific purpose of acquiring the securities being offered: Section 501(c)(3) organizations (i.e., non-profits), corporations, Massachusetts or similar business trusts, or partnerships.[173] Though this list does not include limited liability companies ("LLCs"), which have become a widely adopted entity form since the Commission last updated the accredited investor definition to include additional entities in 1989,[174] a longstanding Commission staff position has been that LLCs satisfying the other requirements of the definition qualify as accredited investors under Rule 501(a)(3).[175] Practitioners often added LLCs to the list of Rule 501(a)(3) entities in subscription agreements, securities purchase agreements, accredited investor questionnaires, and similar documents. The Commission used the opportunity of the Accredited Investor Amendments to add limited liability companies to the list provided in Rule 501(a)(3) to eliminate any question whether limited liability companies were intended to be included.

Limited liability companies typically have managers instead of directors. Prior to the adoption of the Amendments, Rule 501(a)(4) included as an accredited investor any director, executive officer, or general partner of the issuer of the securities being offered or sold. This raised questions of whether a "manager" of an issuer formed as a limited liability company would likewise be considered an accredited

171. Rural Investment Program: Overview, USDA, https://www.rd.usda.gov/programs-services/rural-business-investment-program (last visited Dec. 7, 2020).

172. *See* RBIC Advisers Relief Act, Pub. L. No. 115-417, 132 Stat. 5438 (2019); Consolidated Farm and Rural Development Act, 7 U.S.C. § 2009cc-3(a) (2018). *See* also *Rural Business Investment Program, Overview*, USDA, https://www.rd.usda.gov/programs-services/rural-business-investment-program (last visited Apr. 19, 2021).

173. 17 C.F.R. § 230.501(a)(3) (2021).

174. *See* Regulation D, Securities Act Release No. 33-6825, 54 Fed. Reg. 11369 (Mar. 20, 1989).

175. Accredited Investor Definition, *supra* note 156, at 64247; *see* SEC Div. of Corp. Fin. Interpretive Letter to Wolf, Block, Schorr & Solis-Cohen (Dec. 11, 1996); *see also* SEC Compliance & Disclosure Interpretation, Question No. 255.05 (last updated Nov. 6, 2017), https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

investor and, if so, whether the Commission would amend Rule 501(a)(4) to add "manager" to the list of qualifying titles. The Commission, in the Accredited Investor Definition, noted that the term "executive officer" is defined in Rule 501(f) as "the president, any vice president in charge of a principal business unit, division or function, as well as any other officer who performs a policy making function, or *any other person who performs similar policy making functions for the issuer*."[176] The Commission stated that because a manager of an LLC performs a policy-making function for the issuer equivalent to that of an executive officer of a corporation, it is not necessary to amend Rule 501(a)(4) or Rule 501(f) to specifically include managers of limited liability companies.[177]

d. Other Entities Meeting an Investments-Owned Test

The Accredited Investor Amendments added a new category to the accredited investor definition that includes any entity that owns investments[178] in excess of $5 million and is not formed for the specific purpose of acquiring the securities being offered.[179] The Commission stated in the Accredited Investor Definition that this catch-all category is intended to capture all existing entity forms not already included within Rule 501(a), such as Native American tribes and U.S. and non-U.S. governmental bodies.[180] It further stated it did not believe that enumerating a list of entities in the rule is necessary.[181] Indeed, part of the reason for the new catch-all provision is to capture entity types that may be created in the future.[182]

e. Certain Family Offices and Family Clients

The Accredited Investor Amendments add certain "family offices," as well as such family offices' "family clients," as each term is defined under the Advisers Act, to the definition of accredited investor.[183]

3. Spousal Equivalents

The accredited investor definition has long allowed individuals to include joint income from spouses when calculating joint income under Rule 501(a)(6) and to include spouses when determining net worth under Rule 501(a)(5). The Accredited Investor Amendments update both provisions to include a "spousal equivalent," which is defined as a cohabitant occupying a relationship generally equivalent to that of a spouse.[184]

176. Accredited Investor Definition, *supra* note 156, at 64247 (emphasis added).
177. *Id.*
178. *Id.* at 64249. "Investments" is used as defined in Rule 2a51-1(b) under the Company Act.
179. 17 C.F.R. § 230.501(a)(9) (2021); Accredited Investor Definition, *supra* note 156, at 64249.
180. Accredited Investor Definition, *supra* note 156, at 64247, 64249.
181. *Id.* at 64249.
182. *Id.*
183. *Id.* at 64250.
184. *Id.* at 64251. The Commission noted that it had previously used "spousal equivalent" in the Advisers Act and Title III of the Jumpstart Our Business Startups Act.

F. Commission Adopts Rules to Modernize and Simplify Disclosure

On August 26, 2020, the Commission continued its modernization and simplification of Regulation S-K by adopting amendments to various disclosure items.[185] Specifically, the Commission amended Items 101, 103, and 105 of Regulation S-K, relating to an issuer's description of business, legal proceedings, and risk factors, respectively. The amendments are a product of the Commission's efforts to update the disclosure requirements under Regulation S-K, better known as the "Disclosure Effectiveness Initiative," which was launched by a report mandated under section 108 of the Jumpstart Our Business Startups Act.[186] The report was published in December 2013 and contains a comprehensive review of Regulation S-K.[187] It also provides recommendations to simplify and modernize the registration process.[188] The simplification and modernization goals focus on the information that is to be disclosed, where and how it is disclosed, and the ways in which technology can be used to facilitate these efforts.[189] In connection with the report and the Disclosure Effectiveness Initiative, the Commission published a concept release in 2016 seeking public comment on modernizing certain business and financial disclosure requirements in Regulation S-K.[190]

In developing the amendments, the Commission considered input from public comment letters, the staff's experience reviewing Regulation S-K disclosures, and the changing regulatory and business landscape.[191] The amendments are largely principles-based, and intended to result in enhanced readability, improved disclosure, lower costs, and more streamlined information for investors to make informed investment decisions.[192] The Commission regards these amendments as some of the most significant changes to Items 101, 103, and 105 in over thirty years.[193] The amendments became effective on November 9, 2020, and filings after that date should comply with the revised items of Regulation S-K. Staff of the Division of Corporation Finance has published guidance on specified transition matters relating to certain filings.[194] This part discusses

185. Modernization of Regulation S-K Items 101, 103, and 105, Release No. 33-10825, 85 Fed. Reg. 63726 (Oct. 8, 2020) (to be codified at 17 C.F.R. pts. 229, 239 & 240).

186. Pub. L. No. 112-106, § 108, 126 Stat. 306, 308 (2012).

187. *See* U.S. Sec. & Exch. Comm'n, Report on Review of Disclosure Requirements in Regulation S-K (Dec. 2013).

188. *Id.* at 92–104.

189. Press Release, U.S. Sec. & Exch. Comm'n, Commission Proposes to Modernize Disclosure of Business, Legal Proceedings, and Risk Factors Under Regulation S-K (Aug. 8, 2019), https://www.sec.gov/news/press-release/2019-148.

190. Business and Financial Disclosure Required by Regulation S-K, Release No. 33-10064, 81 Fed. Reg. 23915 (Apr. 22, 2016) [hereinafter Concept Release].

191. Modernization of Regulation S-K Items 101, 103, and 105, *supra* note 185, at 63727.

192. *Id.*

193. *Id.*

194. *Transitional FAQs Regarding Amended Regulation S-K Items 101, 103, and 105*, U.S. Sec. & Exchange Commission (Nov 5, 2020), https://www.sec.gov/corpfin/transitional-faqs-amended-regulation-s-k-items-101-103-105.

the changes to Item 101, 103, and 105 and the intended impact of these changes. This part also discusses two Commissioner dissents on the adoption of the amendments, noting the omission in addressing matters such as climate change and other subjects.

1. Item 101: Description of Business

The amendments focused on Items 101(a) and 101(c). Previously, Item 101(a) required a description of the general development of a company's business over the last five years (three years for smaller reporting companies), or such shorter period as a company may have been in business.[195] The changes to Item 101(a) eliminated the five-year and three-year timeframes and now apply a materiality standard to all of a company's disclosures relating to the general development of its business. In addition, for filings subsequent to an initial effective registration statement, a company may provide an update of the general development of its business disclosing only "material" updates that occurred since the last filing containing a full description of the business's development.[196] If this option is chosen, the fuller business development description must be incorporated by reference into the updated discussion, which must continue to comply with the prohibitions of Rule 411(e) under the Securities Act and Rule 12b-23(e) under the Exchange Act regarding incorporating information from third-party materials.[197] The amendments revised the existing prescribed disclosure topics to make them more principles-based. They replaced the list of required disclosure topics with a non-exclusive list of the types of information that a company may need to disclose. The amendments also implemented a new disclosure topic relating to business strategy: if a company previously disclosed its business strategy, it must continue to provide updates to that strategy, if material to an understanding of the development of its business, rather than removing it altogether.[198] Identical changes were made to Item 101(h) related to smaller reporting companies.[199]

Item 101(c) previously required a narrative description of the company's reportable business segments, specifying twelve different topics that the discussion was required to include if material to the understanding of the business segment.[200]

The amendments replaced the specific list of topics with a list of general disclosure topic examples, including human capital resources.[201] The list of disclosure topics is intended to facilitate application of the principles-based revisions to Item 101. The new list is nonexclusive, and issuers must continue to discuss any of the previous topics that were material to its reporting segments.[202] Many

195. Modernization of Regulation S-K Items 101, 103, and 105, *supra* note 185, at 63728–31.
196. *Id.* at 63730–32.
197. *Id.*
198. *Id.*
199. *Id.*
200. *Id.* at 63732–33.
201. *Id.* at 63733–40.
202. *Id.* at 63736.

of the listed disclosure topics received limited or no comments at the proposal stage. The two topics that engendered the most comments related to disclosures with respect to a company's compliance with governmental regulations and human capital resources.

The previous requirement for companies to disclose the material effects of compliance with environmental laws dated from amendments adopted in 1973 and 1976 in light of the National Environmental Policy Act of 1969.[203] The Commission had previously noted that although there has been no separate line item regarding disclosure of government regulation more generally if material to a company's business, many companies were including such disclosure. In light of what it considered to be a common practice, the Commission included the material effects of compliance with government regulations, not just environmental laws, as a listed disclosure topic.[204] This disclosure, if provided, should address capital expenditures, earnings and competitive position of the company, and specifically cover estimated capital expenditures for environmental control facilities for the current fiscal year and any other material subsequent period.

Previously, Regulation S-K had called for very little disclosure with respect to a company's employees or labor force. In response to comments that the Commission had received on the Concept Release and a rule writing petition the Commission received in 2017,[205] the Commission proposed a broader requirement for companies to provide a description of a company's human capital resources.[206] In adopting the new disclosure topic, the Commission noted that human capital is a material resource for many companies and that human capital disclosure is important for many investors. As adopted, the amendments identify various human capital measures and objectives that address attraction, development, and retention of personnel. The Commission has emphasized that these areas are examples and not mandates. The Commission expects companies to tailor their disclosure to their unique business, workforce, and facts and circumstances.[207]

2. Item 103: Legal Proceedings

Item 103 requires companies to disclose any material pending legal proceedings, specifying where (i.e., name of court/agency) and when the proceedings are to be adjudicated, the main parties involved, and descriptions of the factual basis alleged and the relief sought.[208] The Commission did not amend the information required to be disclosed under this item, although the amendment now

203. Pub. L. No. 91-190, 83 Stat. 852 (1970).

204. Modernization of Regulation S-K Items 101, 103, and 105, *supra* note 185, at 63737.

205. *See* Rulemaking Petition to Require Registrants to Disclose Information About Their Human Capital Management Policies, Practices and Performance, SEC File No. 4-711 (July 6, 2017).

206. Modernization of Regulation S-K Items 101, 103, and 105, Release No. 33-10688, 84 Fed. Reg. 44348 (Aug. 23, 2019).

207. Modernization of Regulation S-K Items 101, 103, and 105, *supra* note 185, at 63729.

208. *Id.* at 63740.

expressly allows for this information to be furnished via hyperlink or cross-reference to other relevant discussion in the disclosure document in order to avoid duplicative disclosure.[209]

For environmental proceedings involving the government, the amendment increased the potential monetary sanctions threshold required to disclose such proceedings from $100,000 to $300,000 to adjust for inflation.[210] The amendment provided additional latitude by allowing companies to determine their own minimum dollar threshold amount, provided that such designation will result in disclosure of material information concerning such proceedings.[211] If a company does not elect to use the $300,000 amount, it must state the specific threshold amount in each annual and quarterly report, and the threshold may not exceed the lesser of $1 million or 1 percent of the current assets of the company and its subsidiaries on a consolidated basis.[212]

3. Item 105: Risk Factors

Prior to the amendments, Item 105 required issuers to disclose the most significant risks that may negatively impact their business and viability as an investment.[213] The disclosure was to be concise and organized logically. Risk factors are required to be included in prospectuses under the Securities Act and annual reports under the Exchange Act.[214]

Item 105 was amended to require disclosure of risk factors that are "material" rather than "significant," along with an explanation of how each factor specifically affects the issuer or its securities.[215] The amendment strongly discourages disclosure of generic risk factors that are not specifically tailored to discuss the effect on the issuer.[216] In addition, the amendment effects a change to the organizational format of risk factor disclosure. The risk factors must be grouped under relevant headings in addition to the subcaptions required under the original rules.[217] Any risk factors that are material but are general must be grouped together under a separate caption and at the end of the section.[218] The amendment affords issuers flexibility in the order in which the risk factors are presented, rather than requiring issuers to prioritize certain factors over others.[219] The new rule also requires issuers to include in the disclosure document a summary of the risk factors if the section exceeds fifteen pages.[220] The summary,

209. *Id.* at 63742.
210. *Id.*
211. *Id.*
212. *Id.*
213. *Id.*
214. Smaller reporting companies are not required to provide risk factor disclosure in their Exchange Act registration statements and periodic reports.
215. Modernization of Regulation S-K Items 101, 103, and 105, *supra* note 185, at 63743–46.
216. *Id.*
217. *Id.* at 63746.
218. *Id.*
219. *Id.*
220. *Id.* at 63743.

limited to two pages, must appear at the beginning of the section and present concise bulleted or numbered statements summarizing only the principal factors that contribute to the risk of investing in the issuer.[221]

4. Dissenting Opinions

The amendments to Items 101, 103, and 105 were adopted by a three-to-two Commissioner vote. The two dissenting Commissioners, Allison Herren Lee and Caroline Crenshaw, criticized the amendments for not requiring specific disclosure with respect to environmental, social and governance ("ESG").[222]

G. Commission Amends Requirements for Statistical Disclosures for Bank and Savings and Loan Registrants, Replacing Industry Guide 3

On September 11, 2020, the Commission adopted, in substantially the form it had proposed, amendments to the requirements for statistical disclosures that bank and savings and loan registrants provide to investors.[223] The rules rescind Industry Guide 3, *Statistical Disclosure by Bank Holding Companies* ("Guide 3"),[224] codify certain Guide 3 disclosures into a new Subpart 1400 of Regulation S-K, eliminate other Guide 3 disclosures that overlap with other Commission disclosure requirements, GAAP, or IFRS, and add certain credit ratio disclosure requirements. According to the Commission, the rules aim to streamline compliance efforts, decrease reporting burdens for registrants, and enhance comparability among issuers.[225] The changes also form part of the Commission's Division of Corporation Finance's ("CorpFin") Disclosure Effectiveness Initiative.

1. Background

Guide 3 was first published in 1976 as a "convenient reference" to the statistical disclosures sought by CorpFin in registration statements and other disclosure documents filed by bank holding companies ("BHCs").[226] Guide 3 calls for statistical disclosures related to interest-earning assets and interest-bearing liabilities of BHCs.[227] These disclosures were designed to assist investors in evaluating loan portfolio risk characteristics, among others, of BHCs. Guide 3 disclosures

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221. *Id.*

222. Regulation S-K and ESG Disclosures: An Unsustainable Silence, Statement of Commissioner Allison Herren Lee (Aug. 26, 2020), https://www.sec.gov/news/public-statement/lee-regulation-s-k-2020-08-26; State of the "Modernization" of Regulation S-K Items 101, 103, and 105, Statement of Commissioner Caroline Crenshaw (Aug. 26, 2020), https://www.sec.gov/news/public-statement/crenshaw-statement-modernization-regulation-s-k.

223. Update of Statistical Disclosures for Bank and Savings and Loan Registrants, Release No. 33-10835, 85 Fed. Reg. 66108 (Oct. 16, 2020) (to be codified at 17 C.F.R. pts. 210, 229 & 249).

224. *Commission Industry Guides*, U.S. Sec. & Exchange Commission, https://www.sec.gov/about/forms/industryguides.pdf (last visited Apr. 10, 2021).

225. 85 Fed. Reg. at 66122, 66127.

226. Guides for Statistical Disclosure by Bank Holding Companies, Release No. 33-5735, 41 Fed. Reg. 39007 (Aug. 31, 1976).

227. 85 Fed. Reg. at 66123.

are commonly found in tabular form in the Description of Business or MD&A sections of a registrant's Commission filings.[228]

While Guide 3 has been amended on a few occasions, its last substantive revision was more than thirty years ago, in 1986.[229] Since, a number of significant financial reporting changes have occurred, including the issuance of new accounting standards by the Financial Accounting Standards Board (FASB) and the IASB.[230] In March 2017, the Commission published a request for comment seeking public input on possible changes to Guide 3.[231] It noted that the financial services industry has dramatically changed since Guide 3 was published, and consequently, existing guidance may not always reflect recent industry developments or changes in accounting standards related to financial and reporting requirements.[232] The proposing release[233] was published by the Commission on September 17, 2019, and generally, the comments on the proposing release supported changes.[234] Below, we summarize the key elements of the final rules.

2. Codification, Elimination, and Addition

Certain Guide 3 disclosures will be updated and codified into a new Subpart 1400 of Regulation S-K.[235] Guide 3 and other industry guides do not constitute Commission rules, nor do they bear official Commission approval.[236] Rather, they represent disclosure policies and practices followed by CorpFin in administering the federal securities laws. The Commission's final rules elevate the required disclosures from CorpFin guidance to Commission rule. The final rules would *not* codify a number of Guide 3 disclosure items that currently overlap with existing Commission rules, GAAP, or IFRS, in effect eliminating such Guide 3 disclosure requirements.[237]

3. Scope and Applicability

Subpart 1400 applies to a bank, bank holding company, savings and loan association, or savings and loan holding company (collectively, "bank and savings and loan registrants").[238] Subpart 1400 applies to both domestic registrants and

228. *Id.* at 66109.
229. *Id.* at 66123.
230. *Id.* at 66118.
231. Request for Comment on Possible Changes to Industry Guide 3 (Statistical Disclosure by Bank Holding Companies), Release No. 33-10321, 85 Fed. Reg. 12757 (Mar. 7, 2017) (to be codified at 17 C.F.R. pts. 210, 211, 229, 231 & 241); *see also* Business and Financial Disclosure Required by Regulation S-K, Release No. 33-10064, 81 Fed. Reg. 23915 (Apr. 22, 2016) (to be codified at 17 C.F.R. pts. 210, 223, 229, 230, 232, 239, 240 & 249).
232. 85 Fed. Reg. at 12757.
233. Update of Statistical Disclosures for Bank and Savings and Loan Registrants, Release No. 33-10688, 84 Fed. Reg. 52936 (proposed Oct. 3, 2019).
234. Update of Statistical Disclosures for Bank and Savings and Loan Registrants, *supra* note 223, at 66108.
235. *Id.*
236. *Id.*
237. *Id.*
238. *Id.* at 66141.

foreign registrants. There are no specific accommodations for issuers that report in IFRS.[239] Securities Act Rule 409 and Exchange Act Rule 12b-21 already allow registrants, not just foreign registrants, to seek relief from providing information that is "unknown and not reasonably available to the registrant" or would involve "unreasonable effort or expense."[240] To the extent that a foreign registrant that reports in IFRS encounters difficulties, it can rely on these rules in order to seek relief as needed.[241]

Subpart 1400 reduces the reporting periods previously required under Guide 3 and aligns them with the relevant annual periods required by Commission rules for a registrant's financial statements.[242]

Guide 3 requires BHCs to provide statistical disclosures for each "reported period." Guide 3 defines "reported period" as (i) *five years* of loan portfolio and summary of loan loss experience data, (ii) *three years* for all other information, except that (iii) for all types of information (including under items (i) and (ii) above), registrants with less than $200 million of assets or $10 million or less of net worth may choose to present only *two years* of the required information.[243] "Reported period" includes any additional interim period "necessary to keep the information from being misleading" and such additional interim period should be included "if a material change in the information presented or the trend evidenced thereby has occurred."[244]

Under Subpart 1400, "reported period" is defined as (1) for all disclosures, *each annual period* required by Commission rules for a registrant's financial statements, and (2) any additional interim period subsequent to the most recent fiscal year end if a material change in the information presented or the trend evidenced thereby has occurred.[245] The final rules limit the required credit ratio disclosures to the periods for which financial statements are required.[246] As a result of the final rules, Subpart 1400 would generally reduce the reporting periods and align them with the number of years required by Commission rules to be presented in a registrant's financial statements.

4. Item 1402: Distribution of Assets, Liabilities, and Stockholders' Equity; Interest Rates and Interest Differential

Subpart 1400 is organized as follows and covers five disclosure areas identified by Items 1402 to 1406 below.[247] Item 1402 codifies the requirements

239. *Id.* at 66110.

240. 17 C.F.R. §§ 230.409, 240.12b-21 (2021).

241. Update of Statistical Disclosures for Bank and Savings and Loan Registrants, *supra* note 223, at 66110.

242. *Id.* at 66111–12.

243. *Commission Industry Guides*, *supra* note 224, at 2.

244. *Id.*

245. Update of Statistical Disclosures for Bank and Savings and Loan Registrants, *supra* note 223, at 66141 (to be codified at 17 C.F.R. § 229.1401).

246. *Id.*

247. *Id.* at 66141–42 (to be codified at 17 C.F.R. § 229.1401).

required by item 1 of Guide 3.[248] For each reported period, the registrant must present average balance sheets, which may be condensed from consolidated financial statements, provided that the condensed average balance sheets indicate the significant categories of assets and liabilities, including all major categories of interest-earning assets and interest-bearing liabilities.[249] Major categories of interest-earning assets must include, if material, loans, taxable investment securities, non-taxable investment securities, interest bearing deposits in other banks, federal funds sold, securities purchased with agreements to resell, and other short-term investments.[250] Major categories of interest-bearing liabilities must include, if material, savings deposits, other time deposits, federal funds purchased, securities sold under agreements to repurchase, commercial paper, other short-term debt, and long-term debt.[251] For each period, the registrant must present an analysis of net interest earnings meeting specific requirements.[252] For the interest rates and interest differential analysis, the registrant must provide certain disaggregated disclosures.[253]

5. Item 1403: Investments in Debt Securities

Item 1403 streamlines a number of the investment portfolio disclosures required by item 2 of Guide 3, so that the relevant disclosure item required will now be the "weighted average yield of each category of debt securities not carried at fair value through earnings for which disclosure is required in the financial statements," presented for a specified range of maturities (e.g., due one year or less, within five years, within five to ten years, and after ten years).[254] The registrant must also disclose how the weighted average yield has been calculated.[255] Item 1403 does *not* codify a number of the investment portfolio disclosures currently required by item 2 of Guide 3, such as book value information, maturity analysis of book value information, and disclosures related to investments exceeding 10 percent of stockholders' equity (e.g., issuer name, aggregate book value, and aggregate market value of issuer's securities).[256] These disclosures substantially overlap with GAAP and IFRS requirements.[257]

6. Item 1404: Loan Portfolio

Item 1404 streamlines a number of the loan portfolio disclosures required by item 3 of Guide 3.[258] The following disclosure sub-items are called for under

248. *Id*. at 66113 (to be codified at 17 C.F.R. § 229.1402).
249. *Id*. at 66141.
250. *Id*.
251. *Id*.
252. *Id*.
253. *Id*. at 66113.
254. *Id*. at 66141 (to be codified at 17 C.F.R. § 229.1403).
255. *Id*.
256. *Id*. at 66114.
257. *Id*.
258. *Id*. at 66133.

item 3 of Guide 3: (a) types of loans (e.g., domestic or foreign; commercial, real estate-construction, real estate-mortgage; governments and official institutions, banks and other financial institutions, other loans, etc.), (b) maturities and sensitivities of loans to changes in interest rates, (c) risk elements, and (d) other interest bearing assets.[259] Item 1404 does *not* codify item 3(a) regarding loan category disclosures, item 3(c) regarding loan portfolio risk elements, and item 3(d) regarding other interest bearing assets, all required by Guide 3.[260] The Commission reasoned that similar disclosures are already required under Commission rules, GAAP, and IFRS.[261] Item 1404 codifies the maturity by loan category disclosure required by item 3(b) of Guide 3, but the loan categories are based on the loan categories required to be disclosed in the registrant's GAAP or IFRS financial statements that are due in one year or less, after one year through five years, after five years through fifteen years, and after fifteen years.[262] Item 1404 also requires for each loan category above, to present separately the total amount of loans in each such loan category that are due after one year that have predetermined interest rates, and have floating or adjustable interest rates.[263]

7. Item 1405: Allowance for Credit Losses

Item 1405 streamlines a number of the summary of loan loss experience disclosures required by item 4 of Guide 3, retains but updates the existing ratio of net charge-offs to average loans outstanding under Guide 3, and adds three additional credit ratios related to allowances for credit losses.[264] For each reported period, a registrant must disclose certain credit ratios, along with each component of the ratio's calculations.[265] The ratio for loan category for which disclosure is required in the financial statements is required to be disclosed.[266] The registrant must provide a discussion of the factors that led to material changes in the above ratios or their related components for the periods presented.[267] Item 1405 codifies the requirement to provide a tabular allocation of the allowance disclosures based on the loan categories presented in the registrant's U.S. GAAP financial statements for GAAP filers.[268] This requirement does not apply to IFRS registrants because IFRS already requires this disaggregated information in the financial statements.[269]

259. Commission Industry Guides, *supra* note 224, at 4–7.
260. Update of Statistical Disclosures for Bank and Savings and Loan Registrants, *supra* note 223, at 66115.
261. *Id.*
262. *Id.* at 66141 (to be codified at 17 C.F.R. § 229.1404).
263. *Id.*
264. *Id.* at 66134.
265. *Id.* at 66142 (to be codified at 17 C.F.R. § 229.1405).
266. *Id.*
267. *Id.*
268. *Id.* at 66116.
269. *Id.* at 66117.

8. Item 1406: Deposits

Item 1406 codifies a majority of the deposit disclosures required by item 5 of Guide 3, with some revisions.[270] For each reported period, a registrant must present separately the average amount of and the average rate paid on each of the following deposit categories that are in excess of 10 percent of average total deposits. These are noninterest bearing demand deposits, interest-bearing demand deposits, savings deposits, time deposits, and other.[271]

Additional categories that describe the nature of the deposits can be used if the registrant believes them to be more appropriate.[272] If material, the registrant must present separately domestic deposits and foreign deposits for the amounts reported for the above categories.[273] If material, the registrant also must disclose separately the aggregate amount of deposits by foreign depositors in domestic offices, without identifying the nationality of the depositors.[274]

As of the end of each reported period, the registrant must present separately the amount of uninsured deposits.[275] Also as of the end of the latest reported period, the registrant must state the amount outstanding of the portion of U.S. time deposits, by account, in excess of the FDIC insurance limit or similar state deposit insurance scheme, and time deposits that are otherwise uninsured by time remaining until maturity of (1) three months or less; (2) over three through six months; (3) over six through twelve months; and (4) over twelve months.[276]

9. Elimination of Certain Guide 3 Disclosures Regarding Return on Equity and Assets and Short-Term Borrowings

The rules do *not* codify item 6 of Guide 3, which calls for the following ratios: return on assets, return on equity, dividend payout, and equity to assets ratios.[277] The Commission stated that these ratios, though useful to investors, are not unique to bank and savings and loan registrants, which are the subject of Subpart 1400.[278] Moreover, these ratios may be considered key performance indicators for registrants in general, which, if material to investors and used by management, should be identified and discussed as key performance indicators in a company's MD&A.[279] The rules do *not* codify item 7 of Guide 3, relating to short-term borrowings, except to the extent already provided in Item 1402 above with respect to the average balance and related average rate paid for each major

270. *Id.* at 66120.
271. *Id.* at 66142 (to be codified at 17 C.F.R. § 229.1406).
272. *Id.*
273. *Id.*
274. *Id.*
275. *Id.*
276. *Id.*
277. *Id.* at 66121.
278. *Id.*
279. *Id.*

category of interest-bearing liability disclosures.[280] The Commission believes that other elements currently called for by Item 7 of Guide 3 are already covered by existing Commission rules and financial statement requirements.[281]

10. Related Amendments

Article 9 of Regulation S-X, which applies to the consolidated financial statements filed for BHCs and to financial statements of banks that are included in Commission filings, has been amended to apply not only to BHCs and banks, but also to savings and loan associations and savings and loan holding companies.[282] This aligns the scope of Article 9 of Regulation S-X with the scope of entities covered by Subpart 1400.[283] Item 9-03 of Article 9 of Regulation S-X, Item 404 of Regulation S-K, and certain instructions found in Form 20-F are amended such that the references to Industry Guide 3 therein would now be changed to references to the new Subpart 1400.[284]

11. Effectiveness and Compliance

The final rules became effective on November 16, 2020, except for the amendments to 17 C.F.R. 229.801(c) and 229.802(c), which are effective on January 1, 2023.[285] The existing Guide 3 will be rescinded effective January 1, 2023. The final rules must be applied for the first fiscal year ending on and after December 15, 2021.[286] A registrant that is filing an initial registration statement is not required to apply the final rules until an initial registration statement is first filed containing financial statements for a period on or after the mandatory compliance date.[287] Voluntary early compliance is permitted in advance of the mandatory compliance date, provided that the final rules are applied in their entirety from the date of early compliance.[288]

H. Commission's Amendments to Rule 14a-8 and the Reduction of Shareholder Activism

1. Introduction

On September 23, 2020, the Commission voted to amend Rule 14a-8[289] under the Exchange Act.[290] Rule 14a-8 defines the rights and obligations of shareholders to submit proposals in proxy statements at annual and special

280. *Id.*
281. *Id.* at 66122.
282. *Id.*
283. *Id.*
284. *Id.* at 66122, 66140, 66142.
285. *Id.* at 66108.
286. *Id.* at 66122.
287. *Id.*
288. *Id.*
289. 17 C.F.R. § 240.14a-8 (2021).
290. 15 U.S.C. § 78a (2021).

shareholder meetings of companies subject to the federal proxy rules ("Covered Companies").[291] As described in the Commission's Adopting Release,[292] the amendments modify various portions of the existing rule and, effective on January 4, 2021, apply to shareholder proposals for annual shareholder meetings held in calendar year 2022.[293]

2. Counter to ESG Concerns?

The Rule 14a-8 amendments and another recent rule amendment that the U.S. Department of Labor ("DOL") promulgated regarding ERISA fiduciary duties in making investment decisions appear intended to reduce private market participants' promotion or use of ESG in the capital markets.[294]

3. Reducing Numbers of Shareholder Proposals

Although Rule 14a-8 does not distinguish between shareholders, a shareholder with a majority ownership position in a company need not wait until a shareholders' meeting to make proposals to the board of directors or employ alternative methods for getting the attention of the board or management.[295] Rule 14a-8 enables—but also conditions—the rights of minority shareholders to make proposals at shareholders' meetings. According to the Commission, the Amendments "modernize" Rule 14a-8 by enhancing and increasing the number of conditions necessary for, and reducing the opportunities available

291. Rule 14a-8 defines a "shareholder proposal" as a "recommendation or requirement that the company and/or its board of directors take action, which [the shareholder-proponent] intends to present at a meeting of company's shareholders." Answer to Question 1, 17 C.F.R. § 240.14a-8(a) (2021).

292. Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8, Exchange Act Release No. 89964, 85 Fed. Reg. 70240 (Nov. 4, 2020) (to be codified at 17 C.F.R. § 240.14a-8). The Commission initially had proposed certain amendments to Rule 14a-8 in a proposing release of November 5, 2019. Exchange Act Release No. 87458, 84 Fed. Reg. 66458 (proposed Dec. 4, 2019).

293. The new rule:

> will apply to any proposal submitted for an annual or special meeting to be held on or after January 1, 2022. However, a shareholder that has continuously held at least $2,000 of a company's securities entitled to vote on the proposal for at least one year as of January 4, 2021, and continuously maintains at least $2,000 of such securities from January 4, 2021, through the date he or she submits a proposal, will be eligible to submit a proposal to such company, and need not satisfy the amended share ownership thresholds under Rule 14a-8(b)(1)(i)(A)–(C), for an annual or special meeting to be held prior to January 1, 2023.

85 Fed. Reg. at 70276.

294. The DOL's Employee Benefits Security Administration now requires ERISA plan fiduciaries to select investments based solely on pecuniary factors. *See* Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 81658 (Dec. 16, 2020).

295. 85 Fed. Reg. at 70247 (noting that no shareholders are "precluded from raising matters that are important to them through alternative avenues of engagement" and that "[t]oday's investors are able to engage with companies and other investors in a variety of ways, including via email, video conference calls, one-on-one 'sunny day' meetings, shareholder surveys, and e-forums").

to, minority shareholders seeking to submit shareholder proposals at shareholder meetings.

4. Proposal- and Cost-Reducing Amendments

First, the Amendments increase significantly the threshold ownership requirements required to submit a shareholder proposal. Since 1998, a shareholder needed only to hold common shares with a market value of $2,000 for one year before submitting a shareholder proposal. The Amendments increase the holding period requirement for small shareholders from one year to three years.[296] In addition, the one-year holding period minimum ownership threshold has increased 1,250 percent, from $2,000 to $25,000, and a new, intermediate two-year holding period, which completes the new, three-tiered approach, requires continuous ownership of $15,000 in common stock. In addition, shareholders now are explicitly prohibited from aggregating their shares to satisfy the dollar or duration requirements: "each shareholder must satisfy one of the three ownership thresholds to be eligible to submit or co-file a proposal."[297]

Second, the Amendments impose new documentary requirements—and costs—on those wishing to have proposals submitted. Among the reasons offered for the Amendments are the costs—"largely are borne by the company and its shareholders"—for "processing, analyzing, and voting on the proponent's proposal."[298] The Amendments, however, do not merely reduce the costs on the company and non-proponent or other-proponent shareholders—they enhance the costs to shareholder-proponents by means of enhanced documentary requirements.[299]

Every representative of one or more shareholder-proponents must now include with any proposal documentation containing rule-specified information that enables the company to determine more efficiently the authorization of the representative and the identity, role, and interest (eligibility) of the shareholder-proponent.[300] That information must include the shareholder's signature with the "shareholder's statement supporting the proposal."[301] Shareholder-proponents, whether represented or not, must also provide the company with contact information and a written statement containing availability-to-meet information. The shareholder-proponent must be available to meet within a ten-to-thirty day window measured from the date the proposal is submitted and during the business hours of the company's principal executive offices.[302]

296. 17 C.F.R. § 240.14a-8(b) (2021).

297. 85 Fed. Reg. at 70248 (noting, in passing, that aggregation has been permitted since 1983).

298. *Id.* at 70240.

299. The Adopting Release explicitly recognizes that "[t]he final amendments may impose costs on proponents of shareholder proposals," by either requiring investment of "additional funds to immediately submit a proposal," or requiring a wait before submitting a shareholder proposal. *Id.* at 70277.

300. *Id.* at 70250.

301. *Id.* at 70249.

302. *Id.* at 70253.

Specific business days and times must be given.[303] The company, however, has no obligation to contact or "engage with" the shareholder-proponent.[304]

Third, the Amendments continue the single-proposal rule adopted in 1976, but further restrict the one proposal-per-shareholder meeting to "each person," but not "each shareholder."[305] This rule change is intended to prevent one individual from submitting more than a single proposal, whether as a shareholder-proponent or as a representative of other shareholders.[306]

Finally, the Commission amended Rule 14a-8(i)(12),[307] which restricts the resubmission of a proposal. This amendment excludes proposals if they address "substantially the same subject matter" as any proposals submitted within the preceding five calendar years.[308] The prior exceptions to the resubmission rule permitted resubmission only if (1) the most recent vote occurred within three calendar years and (2) the proposal received an approval of 3 percent or more (if voted on only once), 6 percent or more (if voted on twice), and 10 percent or more (if voted on three or more times). The Amendments have increased these percentages to 5 percent, 15 percent, and 25 percent, respectively.[309]

I. Commission Adopts Significant Changes to Regulation of Exempt Offerings

The Commission, on November 2, 2020, by a three-to-two vote, adopted significant changes to the rules governing capital raising through private offerings and other offerings exempt from registration under the Securities Act.[310] According to the Commission, these changes are designed "to harmonize, simplify, and improve the exempt offering framework" and "to promote capital formation and expand investment opportunities while preserving and improving important investor protections."[311] The Commission also adopted a new integration framework for differentiating separate offerings to replace the former five-factor test that proved so troublesome to apply and sometimes interfered with legitimate

303. "We believe that a shareholder-proponent who elects to require a company to include a proposal in its proxy statement, requiring the company and other shareholders to bear the related costs, should be willing and available to discuss the proposal with the company and not simply rely on its representative to do so." *Id.* at 70254.

304. *Id.*

305. 17 C.F.R. § 240.14a-8(c) (2021).

306. 85 Fed. Reg. at 70255.

307. 17 C.F.R. § 240.14a-8(i)(12) (2021).

308. 85 Fed. Reg. at 70257.

309. *Id.* at 70258.

310. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release No. 33-10884, 86 Fed. Reg. 3496 (Jan. 14, 2021) (to be codified at 17 C.F.R. pts. 227, 229, 230, 239, 240, 249, 270 & 274); *see also* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release No. 33-10763, 85 Fed. Reg. 17956 (proposed Mar. 31, 2020); Concept Release on Harmonization of Securities Offering Exemptions, Release No. 33-10649, 84 Fed. Reg. 30460 (June 26, 2019).

311. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, *supra* note 310, at 3496.

capital raising.[312] The new rules became effective on March 15, 2021. The changes made by the new rules, along with the recently expanded definition of "accredited investor,"[313] will enhance the ability of companies to use exempt offerings to raise capital as an alternative to registered offerings.

1. Changes to Offering Exemptions

The Commission broadened certain of the existing exemptions in a number of ways:

Offering Limits. The amounts that may be offered under the three capital-raising exemptions that currently are capped are increased as follows:

- The Regulation A Tier 2 primary offering limit is increased from $50 million to $75 million and the secondary sales limit is increased from $15 million to $22.5 million. No change is made in the Tier 1 limits, which remain at $20 million for a primary offering and $6 million for a secondary offering.[314]
- The Regulation Crowdfunding limit is increased from $1.07 million to $5 million.[315]
- The Regulation D Rule 504 limit is increased from $5 million to $10 million.[316]

Crowdfunding Investor Limits. The investment limits for investors in Regulation Crowdfunding offerings are loosened by eliminating those limits for accredited investors and by allowing non-accredited investors to rely on the greater of their annual income or net worth in calculating the limit.[317] That limit is in any twelve-month period through a crowdfunding offering (1) the greater of $2,200 or 5 percent of the greater of annual income or net worth, if either is less than $107,000, or (2) 10 percent of the greater of annual income or net worth, but not more than $107,000, if both are at least $107,000.[318] The opportunities to use Regulation Crowdfunding also are expanded by permitting special purpose crowdfunding vehicles that pool investments to be issuers without being classified as an "investment company."[319]

Offering Communications. The restrictions on offering communications are eased in a couple of ways as follows:

312. *Id.* at 3504.
313. Accredited Investor Definition, Release No. 33-10824, 85 Fed. Reg. 64234 (Oct. 9, 2020) (to be codified at 17 C.F.R. pts. 230 & 240).
314. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, *supra* note 310, at 3533.
315. *Id.* at 3536.
316. *Id.* at 3535.
317. *Id.* at 3540.
318. *Id.* at 3536.
319. *Id.* at 3541.

Testing the Waters. New Rule 241 permits use of limited materials to "test the waters" before deciding which exemption to use for sales.[320] Non-binding indications of interest may be solicited, but no solicitation or acceptance of payment or an offer to buy can be made, and anyone who is solicited must be so informed.[321] This generic testing the waters can raise issues because of the subjective nature of the condition that the issuer not have determined the exemption on which to rely, which depends on the issuer's state of mind. However, the principal effect of the ability to test the waters is to avoid the problem of gun-jumping should the issuer decide to undertake a registered offering because under the rule test-the-waters communications are not offers prohibited before filing a registration statement, although they are offers for purposes of antifraud provisions.[322] Regulation A in Rule 255 and Regulation Crowdfunding in Rule 206, which was added by the amendments, have their own test-the-waters provisions, while test the waters in connection with a registered offering is permitted under Rule 163B, although limited to qualified institutional buyers (QIBs) and institutional accredited investors. Written material used to test the waters under Rule 241 must be filed with the Commission if a Regulation A or Regulation Crowdfunding offering is commenced within thirty days of the material's use and if the material is provided to non-accredited investors in a Rule 506(b) offering when securities are sold within thirty days of the material's use.[323]

Testing the waters under Rule 241 can be undertaken with or without there being a general solicitation, but if there is general solicitation, the exemption that is subsequently used would need to be limited to one that permits general solicitation, such as Rule 506(c).[324] The Commission made clear in the adopting release that testing the waters using general solicitation may not be employed to identify investors for an offering in which general solicitation is not permitted, such as Rule 506(b).[325] In that situation, the testing the waters may be deemed to have been the commencement of the offering or it may be considered part of a scheme to evade the registration requirements. Also, any testing the waters activity under Rule 241 remains subject to state blue sky law compliance,[326] which can especially be a hurdle if a subsequent exempt offering is not subject to state preemption.

Demo Days. New Rule 148 excludes certain "demo day" communications that meet specified conditions from being considered a general solicitation and therefore an issuer that participates in such a demo day will not be foreclosed from using an exemption that does not permit general solicitation.[327] A demo day is an event involving more than one issuer as a presenter that is sponsored by

320. *Id*. at 3520.
321. *Id*. at 3522.
322. *Id*. at 3520–21.
323. *Id*. at 3521.
324. *Id*. at 3525.
325. *Id*.
326. *Id*. at 3523.
327. *Id*. at 3518.

certain specified organizations (a higher education institution, government instrumentality, nonprofit entity, or angel investor group, incubator, or accelerator).[328]

The adoption of Rule 148 does not affect previous Commission guidance that it will not be general solicitation if an event is held limited to individuals with whom the issuer or sponsor has a pre-existing substantive relationship or that have been contacted through an informal personal network of financially sophisticated individuals.[329] It also does not foreclose concluding based upon the specific circumstances that the communications did not involve an "offer."

Rule 506 Changes. The information required to be provided to non-accredited investors under Rule 506(b) is reduced by aligning them with those for Regulation A. The accredited investor verification safe harbor under Rule 506(c) is expanded by allowing an issuer to rely on a written representation by an investor whose status as an accredited investor was verified within the prior five years.[330] The Commission reaffirmed that what is required for "reasonable steps to verify" under Rule 506(c) is principles-based and sometimes could be the same as what is necessary for a "reasonable belief" under Rule 506(b).[331]

Increased Uniformity. Some provisions that are common across exemptions, such as bad actor disqualification, have been made more consistent across exemptions.

Regulation S Directed Selling Efforts. Instead of adopting amendments to Regulation S as proposed, the Commission reaffirmed its position that general solicitation permitted in a domestic offering will not be considered to be "directed selling efforts" in connection with a Regulation S offering if the general solicitation was not undertaken for the purpose of conditioning the market in the United States for the securities offered in the Regulation S offering.[332] This approach to assessing whether communications for one offering will affect the exemption for another offering can be useful in considering whether separate offerings will be integrated.[333]

Confidential Information Standard. Unrelated to the exempt offering changes, the Commission adopted amendments to align the standards for redacting confidential information in exhibits filed with the Commission with the U.S. Supreme Court's interpretation of the Freedom of Information Act.[334] Under the new standard, non-material information may be redacted from material contracts if it is information the issuer treats as private and confidential, and the issuer no longer will have to show that disclosure would cause competitive harm.[335]

328. *Id.*
329. *Id.* at 3518.
330. *Id.* at 3526.
331. 17 C.F.R. § 230.506 (2021).
332. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, *supra* note 310, at 3511.
333. 17 C.F.R. § 230.901 (2021).
334. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, *supra* note 310, at 3532.
335. *Id.*

2. Integration of Offerings

Revised Rule 152 will be helpful in reducing the uncertainty and legal risk associated with the integration of otherwise separate offerings by establishing, in place of the well-known but often limiting five-factor test, a general principle that no integration is required if each offering, based on its particular facts and circumstances, meets the requirements for an exemption or complies with the registration requirements.[336] The general principle in Rule 152(a) is accompanied by four non-exclusive safe harbors in Rule 152(b).[337] This new integration framework applies across the board to registered and exempt offerings.[338]

The general principle reflects the approach followed by the Commission in recent years in adopting several specific offering exemptions and in recent Commission interpretive guidance. For an exempt offering prohibiting general solicitation, the issuer must have a reasonable belief that each purchaser in that offering either (1) was not solicited through general solicitation or (2) the issuer or someone (e.g., a broker) acting on its behalf established a substantive relationship with that purchaser prior to commencement of that offering.[339] For concurrent exempt offerings permitting general solicitation, offering materials for one offering may be an offer for another exempt offering and, therefore, that offer must comply with the requirements for offers under the exemption relied on for the other offering (for example, for a Regulation Crowdfunding offering which, although it may involve general solicitation, has more restrictive requirements for offering materials).[340] The Commission makes clear in the adopting release that, similar to the 2007 guidance regarding the ability to do a private offering during the pendency of a registered offering,[341] an issuer would be able to undertake concurrent offerings if it can meet the burden of establishing that investors in the offering that did not permit general solicitation (i.e., the Rule 506(b) offering) were not obtained through the general solicitation activity, with the issuer having a pre-existing substantive relationship with the investor being one way of doing so.[342] The issuer, however, will have the burden of establishing the exemption, and the Commission cautions that mention in offering materials for an offering in which general solicitation is permitted the material terms of the exempt offering prohibiting general solicitation may constitute an offer for that exempt offering and thus violate its prohibition on general solicitation.[343]

Rule 152 will not apply to avoid integration for any transaction or series of transactions that are part of a plan or scheme to avoid the registration

336. *Id.* at 3500.
337. *Id.* at 3506.
338. *Id.* at 3501.
339. *Id.* at 3500.
340. *Id.*
341. Revision of Limited Offering Exemptions in Regulation D, Release No. 33-8828, 72 Fed. Reg. 45115, 45129–30 (proposed Aug. 10, 2007).
342. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, *supra* note 310, at 3504–05.
343. *Id.* at 3505–06.

requirements.[344] This anti-evasion principle reflects the basic purpose of the integration doctrine to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings to ostensibly satisfy an exemption that would not be available for the combined offering.[345]

The four safe harbors under Rule 152(b), which consolidate in one rule some safe harbors that have previously existed, can be useful to avoid uncertainties in applying the general principle.[346] They are as follows:

- *30-day Separation*. Offerings separated by thirty days (a reduction from the existing six-month separation period) would not be integrated, provided in the case of an exempt offering that does not permit general solicitation that follows an offering that permits general solicitation, the issuer has a reasonable belief that each purchaser was not solicited through general solicitation or it or someone acting on its behalf had a pre-existing substantive relationship with the purchaser.[347] The Commission reaffirmed the guidance on what is necessary to establish a pre-existing substantive relationship. In order to prevent avoidance of the numerical non-accredited investor limitation through use of a series of offerings, there may not be more than thirty-five non-accredited investors in offerings under Rule 506(b) during a ninety-day period.[348]

- *Rule 701 and Regulation S*. As is now the case, a firewall would exist for offerings exempt under Rule 701 (employee compensatory plans) and under Regulation S (offshore offerings) so that neither would be integrated with other offerings.[349]

- *Subsequent Registered Offerings*. Offerings for which a registration statement has been filed would not be integrated with a prior terminated or completed offering for which general solicitation is not permitted or, if the terminated or completed offering permitted general solicitation, if sales were made only to QIBs or institutional accredited investors or that offering was terminated or completed more than 30 days before commencement of the registered offering. This safe harbor addresses "gun-jumping" concerns related to the registered offering and replaces prior Rule 152 and Rule 155.[350]

- *Subsequent Exempt Offerings with General Solicitation*. Exempt offerings using permitted general solicitation made after other terminated or completed offerings for which general solicitation is not permitted will not be integrated

344. *Id.* at 3504.
345. *Id.* at 3499.
346. *Id.* at 3506.
347. *Id.* at 3508.
348. *Id.* at 3506–09.
349. *Id.* at 3509.
350. *Id.* at 3511.

> to defeat the subsequent offering.[351] Other provisions of Rule 152 can apply to protect the prior terminated or completed offering from being integrated with the subsequent exempt offering that involved general solicitation. Thus, for example, as made clear by the Commission in the adopting release, an issuer can do sequential Rule 506(b) and Rule 506(c) offerings and can switch from a Rule 506(b) offering to a Rule 506(c) offering, as long as each offering complies with its requirements.[352]

In view of the significance of the concepts of "commencement" and "termination and completion" of offerings, Rule 152(c) and (d) include a non-exclusive list of factors relevant to applying those concepts, which otherwise depend upon the particular facts and circumstances.

3. Conclusion

These revisions will facilitate the ability of companies to raise capital in the private markets. This will be especially significant for smaller and medium-size companies for which the public markets may not be a viable alternative, including those companies for which venture and other institutional private funding may not be available. The revisions will also simplify the ability to conduct contemporaneous and sequential offerings by eliminating uncertainties involved in complying with securities law requirements. Taken as a whole, the new rules represent a significant development in the regulation of exempt securities offerings.

J. Commission Adopts Significant Changes to MD&A and Related Disclosures

On November 19, 2020, the Commission continued its recent efforts to modernize and simplify certain financial disclosure requirements in Regulation S-K by amending Item 303 of Regulation S-K (MD&A) and revising or eliminating several other requirements of Regulation S-K.[353] The Commission adopted these changes "to eliminate duplicative disclosures and modernize and enhance MD&A disclosures for the benefit of investors, while simplifying compliance efforts for registrants."[354] The amendments aim to provide investors with company-specific, tailored disclosure that will enable investors to see a company "through the eyes of management."

1. Effective and Compliance Dates

The amendments became effective February 10, 2021. Companies must comply with the amended rules for their first fiscal year ending on or after August 9,

351. *Id.* at 3514.
352. *Id.* at 3504–05.
353. *See* Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, 86 Fed. Reg. 2080 (Jan. 11, 2021).
354. 86 Fed. Reg. at 2080.

2021 (mandatory compliance date). Companies must apply the amended rules in a registration statement and prospectus that on its initial filing date is required to contain financial statements for a period on or after the mandatory compliance date. Companies may comply with the amendments any time after the effective date as long as they provide disclosure responsive to an amended item in its entirety.

2. Changes to MD&A

The Commission made significant changes to MD&A by adding new requirements to Item 303, deleting some requirements, simplifying some of the instructions to Item 303, and revamping other requirements. The more significant changes to Item 303 of Regulation S-K include:

a. New Paragraph (a)—Objective

The Commission added a new paragraph (a) to Item 303 to clarify the objective of MD&A by incorporating much of previous Instructions 1, 2, and 3 to the Item to emphasize the objective of MD&A for both full fiscal years and interim periods.[355] According to the adopting release, disclosure responsive to this objective requirement generally is expected to better allow an investor to view the company from management's perspective.[356] Prior Items 303(a) and (b) have been recaptioned as Items 303(b) and (c), respectively.[357]

b. Changes to Item 303(a)—Full Fiscal Years—to Be Reflected in New Item 303(b)

Capital Resources. The Commission has revised paragraph (a)(2) to require companies to disclose material cash requirements, including commitments for capital expenditures, the anticipated source of funds needed to satisfy these cash requirements and the general purpose of the cash requirements, as now reflected in new Item 303(b)(1) and amended Item 303(b)(1)(ii).[358] The objective behind this change was to revise the disclosure requirements to account for capital expenditures that are not necessarily capital investments, recognizing that expenditures for human capital or intellectual property have become increasingly important for some companies. The amendments also add product lines as an example of other subdivisions that may need to be discussed where necessary to understand a company's business.[359]

Results of Operations. The Commission made three changes to prior paragraph (a)(3) as now reflected in Item 303(b)(2)(ii).[360] First, companies will be required

355. *See* 17 C.F.R. § 229.303(a) (2021).
356. 86 Fed. Reg. at 2089.
357. *See id.* § 229.303(b)–(c).
358. *Id.*
359. 86 Fed. Reg. at 2091.
360. *Id.*

to disclose known events that are reasonably likely to cause a material change in the relationship between costs and revenues, such as known or reasonably likely future increases in costs of labor or materials or price increases or inventory adjustments. The change uses a disclosure threshold of "reasonably likely," which is consistent with the Commission's guidance on forward-looking statements. Second, companies will be required to disclose the reasons underlying material changes in net sales or revenues. The change codifies existing Commission MD&A guidance. Third, the Commission has eliminated prior paragraph (a)(3)(iv) with regard to specific disclosure with respect to the impact of inflation and changing prices. Companies will still be required to discuss these matters if they are part of a known trend or uncertainty that has had, or is reasonably likely to have, a material impact on net sales or revenue. This will allow companies to focus on material disclosure that is tailored to their business, facts, and circumstances.

Off-Balance Sheet Arrangements. The Commission eliminated prior paragraph (a)(4) and replaced it with an instruction to Item 303 that requires companies to discuss commitments and obligations arising from arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on their financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements or capital resources, even when the arrangements result in no obligation being reported in the consolidated balance sheet.[361] As a result of this change, companies should consider off-balance sheet arrangements within the broader context of their MD&A.

Tabular Disclosure of Contractual Obligations. The Commission eliminated this disclosure requirement previously contained in paragraph (a)(5).[362] However, in a change from the proposal, the Commission amended Item 303(b) to specifically require disclosure of material cash requirements from known contractual and other obligations as part of a liquidity and capital resources discussion, in recognition of commenter concerns that such information may be lost with the elimination of Item 303(a)(5).

Material Changes in Line Items. The Commission moved a portion of prior Instruction 4[363] into new Item 303(b) to clarify that where there are material changes in a line item, including those that offset each other, disclosure of the underlying reasons for these material changes in quantitative and qualitative terms is required.[364] The change codifies existing Commission MD&A guidance.

Critical Accounting Estimates. The Commission added a new paragraph (b)(4) to Item 303 to explicitly require disclosure of critical accounting estimates.[365] This change is intended to codify existing Commission MD&A guidance, eliminate disclosure that duplicates the financial statement discussion of significant

361. *See id.* § 229.303.
362. *See* 17 C.F.R. § 229.303(a)(5) (2017).
363. *See id.* § 229.303, Instr. 4.
364. 86 Fed. Reg. at 2082.
365. *See* 17 C.F.R. § 229.303(b)(4) (2021).

policies and promote enhanced analysis of measurement uncertainties. The rule directs companies to provide qualitative and quantitative information necessary to understand the estimation uncertainty and the impact the critical accounting estimate has had or is reasonably likely to have on financial condition or results of operations to the extent the information is material and reasonably available. This information should include why each critical accounting estimate is subject to uncertainty and, to the extent the information is material and reasonably available, how much each estimate and/or assumption has changed over a relevant period and the sensitivity of the reported amount to the methods, assumptions, and estimates underlying its calculation. Notably, in a change from the proposal and in response to concerns of commenters that the proposed amendments could require disclosure that is not material, or is otherwise costly to prepare, Item 303(b)(3) now more clearly states that the "material and reasonably available" qualifier "applies to all information about a critical accounting estimate that has had or is reasonably likely to have a material impact on financial condition or results of operations, whether qualitative or quantitative, including whether the information relates to sensitivity of the reported amount or how much the estimate has changed."[366]

c. Change to Prior Item 303(b)—Quarterly Periods—Reflected in New Item 303(c)

Item 303(c) allows companies to compare their most recently completed quarter to either the corresponding quarter of the prior year or to the immediately preceding quarter.[367] Under the amendments, if a company changes the comparison from the prior interim period comparison, it will have to explain the reason for the change and present both comparisons in the filing where the change is announced.

d. Deletions to Item 303

In light of the changes and deletions to Item 303(a) discussed above, the Commission also deleted prior paragraphs (c), dealing with a safe harbor for the forward-looking statements, and (d), dealing with the requirements relating to smaller reporting companies.[368]

3. Changes to Supplementary Financial Information and Selected Financial Data

The Commission also amended Item 302 of Regulation S-K (Supplementary Financial Information)[369] and eliminated Item 301 of Regulation S-K (Selected

366. *Id.* § 229.303(b)(3).
367. *Id.* § 229.303(c).
368. *Id.* § 229.303(d)–(e).
369. *Id.* § 229.302.

Financial Data).[370] The changes are designed to modernize the disclosure requirements in light of technological developments, simplify disclosure requirements, reduce repetition, and better focus disclosure on material information.

In a change from the proposal to eliminate Items 302(a) and 302(b), the Commission amended the prior Item 302(a) requirement to provide two years of tabular selected quarterly financial data by replacing it with a principles-based requirement that requires disclosure only when there are one or more retrospective changes that pertain to the statements of comprehensive income for any of the quarters within the two most recent fiscal years and any subsequent interim period for which financial statements are included or required to be included by Article 3 of Regulation S-X[371] and that, individually or in the aggregate, are material. When this disclosure is required, companies will need to provide an explanation of the reasons for the material changes and to disclose, for each affected quarterly period and the fourth quarter in the affected year, summarized financial information related to the statements of comprehensive income (as specified in Rule 1-02(bb)(ii) of Regulation S-X)[372] and earnings per share reflecting such changes. The amendments did not change the type of companies that are not required to provide disclosure pursuant to Item 302(a), such as first-time registrants conducting an initial public offering or companies that are only required to file reports pursuant to section 15(d) of the Exchange Act. Amended Item 302(a) applies beginning with the first filing on Form 10-K after the company's initial registration of securities under sections 12(b) or 12(g) of the Exchange Act. Because the FASB has not finalized amendments to U.S. GAAP that would require incremental disclosure called for by Item 302(b), the Commission has not eliminated Item 302(b) but may do so in the future.

4. Foreign Private Issuers

Consistent with the changes discussed above and for similar reasons, the Commission adopted conforming changes to Form 20-F (the annual report filed by FPIs) and Form 40-F (the annual report filed by Canadian issuers pursuant to the MJDS).

K. Commission Adopts Rules Requiring Disclosure of Payments by Resource Extraction Issuers

On December 16, 2020, the Commission adopted rules requiring Commission reporting companies engaged in the commercial development of oil, natural gas, or minerals ("resource extraction issuers") to provide annual disclosure on Form SD of payments made to certain governmental entities.[373] The final

370. *See* 17 C.F.R. § 229.301 (2017).

371. *See* 17 C.F.R. § 210.3-02 (2018).

372. *See* 17 C.F.R. § 210.1-02 (2021).

373. Disclosure of Payments by Resource Extraction Issuers, Release No. 34-90679 (Dec. 16, 2020) (to be codified at 17 C.F.R. pts. 240 & 249b).

rules implement section 13(q) of the Exchange Act,[374] which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).[375] Section 13(q) of the Exchange Act directs the Commission to issue rules requiring resource extraction issuers to submit an annual report containing information about payments "made by the resource extraction issuer, a subsidiary of the resource extraction issuer, or an entity under the control of the resource extraction issuer to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals . . ."[376]

This is the third time the Commission has adopted rules under section 13(q). The Commission initially adopted rules in August 2012, but the rules were challenged in court and vacated in July 2013 by the U.S. District Court for the District of Columbia.[377] The Commission again adopted rules in June 2016, but those rules were subsequently disapproved by Congress and the president under the Congressional Review Act (the "CRA"), which had the effect of vacating the adopted rules and requiring the Commission to draft new rules not "substantially the same" as the disapproved rules.[378] On December 18, 2019, the Commission proposed rules intended to address the concerns underlying Congress's action under the CRA.[379] The final rules adopted on December 16, 2020, are largely the same as the proposed rules.

In order to comply with the final rules, resource extraction issuers will be required to report certain types of payments (defined by the rule) that are "not de minimis" and made in furtherance of the commercial development of oil, natural gas, or minerals. A payment is defined as "not de minimis" if the payment—either made as a single payment or as a series of payments—is equal to or greater than $100,000. Disclosure is required at the project level, with "project" defined by three criteria:

(i) the type of resource being commercially developed;

(ii) the method of extraction; and

(iii) the major subnational political jurisdiction where the commercial development of the resource is taking place.[380]

The information required by the rules must be furnished, and not filed, which limits the resource extraction issuer's liability under section 18 of the Exchange Act.[381] The rules also provide for two conditional exemptions to the disclosure

374. 15 U.S.C. § 78m(q) (2018).

375. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1504, 124 Stat. 1376, 2220 (2010).

376. 15 U.S.C. § 78m(q)(2)(A) (2018).

377. Am. Petroleum Inst. v. SEC, 953 F. Supp. 2d 5 (D.D.C. 2013).

378. Congressional Review Act, 5 U.S.C. § 801 (2018).

379. Disclosure of Payments by Resource Extraction Issuers, Release No. 34-87783, 85 Fed. Reg. 2522 (Jan. 15, 2020) (to be codified at 17 C.F.R. § 240.13q-1).

380. 85 Fed. Reg. at 2536.

381. 15 U.S.C. § 78r (2018).

obligation in situations where the required disclosure is prohibited by a foreign law or a pre-existing contract.

In addition to approving the adopting release, the Commission also adopted an order that provides an enumerated list of five alternative disclosure regimes that resource extraction issuers may rely on to satisfy their Commission reporting obligation under new Rule 13q-1.[382] Adopting a separate order provides future Commissions with the convenience of more easily amending the order to remove or add alternative disclosure regimes without having to amend the adopting release itself.

Compliance with the new rules will be required two years after the effective date of the rule, which is sixty days after publication in the Federal Register. Following the two-year transition period, the Form SD reporting these payments must be furnished within 270 days after the end of the resource extraction issuer's fiscal year. Smaller reporting companies and emerging growth companies are exempt from the reporting requirements unless subject to similar requirements under an alternative reporting regime. Companies that complete an initial public offering obtain further relief in that they are not required to comply until the fiscal year following the year in which the initial public offering is completed.

382. Order Recognizing the Resource Extraction Payment Disclosure Requirements of the European Union, the United Kingdom, Norway, and Canada as Alternative Reporting Regimes that Satisfy the Transparency Objectives of Section 13(q) Under the Securities Exchange Act of 1934, Release No. 34-90680 (Dec. 16, 2020); Order Recognizing the Resource Extraction Payment Disclosure Requirements of the European Union, Canada and the U.S. Extractive Industries Transparency Initiative as Substantially Similar to the Requirements of Rule 13q-1 Under the Securities Exchange Act of 1934, 81 Fed. Reg. 49163 (July 27, 2016), https://www.govinfo.gov/content/pkg/FR-2016-07-27/pdf/2016-15677.pdf.

Accounting Developments 2020

In 2020, the Financial Accounting Standards Board (the "FASB") issued eleven Accounting Standards Updates ("ASUs") to its Accounting Standards Codification ("ASC" or the "Codification"), compared to twelve ASUs in 2019. Two of the ASUs issued in 2020 deferred for certain entities the effective dates of ASUs related to revenue and leases[1] and the financial reporting requirements for long-duration contracts issued by insurance entities.[2] Three of the 2020 ASUs simplify, clarify, or make targeted improvements to standards relating to reference rate reform,[3] convertible instruments and derivatives,[4] and accounting for contributions of non-financial assets by not-for-profit entities.[5] Two of the ASUs revise sections of the Codification to reflect amendments to the financial reporting rules in Regulation S-X[6] adopted by the U.S. Securities and Exchange Commission ("SEC") and a new SEC Staff Accounting Bulletin.[7] The FASB issued one ASU that articulates a consensus of the FASB's Emerging Issues Task Force (the "EITF")[8] and did not issue any ASUs that articulate a proposal by the FASB's Private Company Council (the "PCC").

The EITF, which was formed in 1984, seeks to address emerging accounting issues before divergent approaches to those issues become widespread.[9] The FASB must approve all consensuses reached by the EITF. The EITF is chaired by the FASB's technical director, has members from the auditing profession and from the preparer and financial statement user communities, and observers from the FASB board, the SEC, the Financial Reporting Executive Committee of the American Institute of Certified Accountants (the "AICPA"), and the PCC.[10]

The PCC was formed by the Board of Trustees of the Financial Accounting Foundation (the "FAF") in May 2012 to improve the process of setting accounting standards for private companies. The PCC determines whether exceptions or modifications to U.S. Generally Accepted Accounting Principles ("GAAP"), including ASUs being considered by the FASB, are appropriate to address the

1. *See infra* section A.4.
2. *See infra* section A.10.
3. *See infra* section A.3.
4. *See infra* section A.5.
5. *See infra* section A.6.
6. *See infra* section A.1.
7. *See infra* section A.8.
8. *See infra* section B.1.
9. *Emerging Issues Task Force (EITF), About the EITF*, Fin. Acct. Standards Board, https://www.fasb.org/home (last visited Feb. 9, 2021).
10. *Id.*

needs of users of private company financial statements.[11] The PCC also is responsible for advising the FASB on the appropriate treatment for private companies for items on the FASB's technical agenda.[12] The FASB must endorse any proposed exceptions or modifications to GAAP proposed by the PCC.[13] Similar to the EITF, the PCC's members represent the auditing profession, preparers and financial statement users, and they must have significant experience conducting audits or preparing or using private company financial statements.[14] A FASB board member serves as liaison to the PCC, and the FASB staff provides technical and administrative support to the PCC.[15]

The FASB's technical agenda includes a standing project to address feedback received from stakeholders about the Codification.[16] Issues considered through this project are limited to minor changes that clarify the Codification or correct unintended consequences. They are not expected to have a significant impact on accounting practice.[17] One of the ASUs issued in 2020 was part of the Codification improvements project.[18] Two other ASUs issued in 2020 address matters that are similar to the issues addressed through the Codification improvements project, but the FASB decided to issue separate updates to increase stakeholder awareness of the amendments and to expedite the improvement process.[19] These two updates clarify various aspects of the financial instruments guidance[20] and the guidance related to callable debt securities.[21]

The following discussion summarizes the ASUs issued by the FASB in 2020.

A. ASUs Originated by the FASB

1. Credit Losses and Leases—Updates to SEC Sections in the Codification

In February 2020, the FASB issued ASU No. 2020-02,[22] which amends ASC Topic 326, Credit Losses ("ASC 326"). The update adds a paragraph to include SEC Staff Accounting Bulletin No. 119.[23] SAB 119 revises the SEC staff's interpretive guidance on allowances for credit losses to conform to ASC 326. Specifically, SAB 119 updates existing staff guidance with respect to methodologies

11. *Private Company Council (PCC), History of Establishing the PCC*, Fin. Acct. Standards Board, https://www.fasb.org/pcc/history (last visited Feb. 9, 2021).
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Technical Agenda, Codification Improvements (formerly Technical Corrections and Improvements), Project Objective and Background*, Fin. Acct. Standards Board, https://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdateExpandPage&cid=1176170469414 (last visited Feb. 9, 2021).
17. *Id.*
18. *See infra* section A.9.
19. *See infra* sections A.2, A.7.
20. *See infra* section A.2.
21. *See infra* section A.7.
22. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-02, Financial Instruments—Credit Losses (Topic 326) and Leases (Topic 842) (Feb. 2020) [hereinafter ASU 2020-02].
23. SEC Release No. SAB 119 (Nov. 25, 2019) [hereinafter SAB 119].

and supporting documentation for measuring credit losses under an expected credit loss model, focusing on the documentation the staff would normally expect entities engaged in lending transactions to prepare and maintain to support estimates of current expected credit losses for loan transactions. The new guidance in SAB 119 applies upon an entity's adoption of ASC 326.

ASU 2020-02 also updates the Transition and Open Effective Date section of ASC Topic 842, Leases ("ASC 842"). The transition provisions in ASC 842 require a public business entity, and certain other entities, to adopt ASC 842 for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. ASU 2019-10 deferred the effective date for all other entities to financial statements for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.[24] In December 2019, the SEC staff announced that it would not object to a public business entity that otherwise does not meet the definition of a public business entity, except for a requirement to include (or the inclusion of) its financial statements or financial information in another entity's filing with the SEC, adopting ASC 842 for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021, consistent with the deferred effective dates provided in ASU 2019-10. ASU 2020-02 adds a note to ASC 842 to reflect the SEC staff's views.

2. Improvements to Financial Instruments Guidance

In March 2020, the FASB issued ASU No. 2020-03,[25] which addresses seven issues brought to the FASB's attention by stakeholders about various aspects of the financial instruments guidance, including the current expected credit losses (CECL) standard issued in 2016. This ASU is consistent with the FASB's ongoing Codification improvements project; however, the FASB issued a separate update for these changes to increase stakeholder awareness of the amendments and to expedite the improvement process.[26]

The following issues were addressed in ASU 2020-03:

Issue 1: Fair Value Option Disclosures. In 2016, the FASB updated ASC Topic 825, Financial Instruments ("ASC 825") to address certain aspects of recognition, presentation, and disclosure of financial instruments.[27] Among other things, those amendments eliminated the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities. Stakeholders

24. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-10, Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates (Nov. 2019) [hereinafter ASU 2019-10].

25. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-03, Codification Improvements to Financial Instruments (Mar. 2020) [hereinafter ASU 2020-03].

26. *Id.*

27. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (Jan. 2016) [hereinafter ASU 2016-01].

questioned whether entities other than public business entities are required to provide the fair value option disclosures required in paragraphs 825-10-50-24 through 50-32.[28] Because financial assets and financial liabilities on which the fair value option has been elected are measured at fair value and not at amortized cost basis, the FASB concluded that all entities are subject to the fair value option disclosures.[29] ASU 2020-03 amended ASC 825 to clarify that the disclosures apply to all entities that have elected the fair value option.

Issue 2: Applicability of Portfolio Exception in ASC 820 to Nonfinancial Items. In 2018, the FASB issued a Codification improvement to clarify that portfolios of financial instruments and nonfinancial instruments accounted for as derivatives under ASC Topic 815, Derivatives and Hedging ("ASC 815") are permitted to use the portfolio exception to valuation.[30] Previously, portfolios that included nonfinancial instruments had been excluded unintentionally from the portfolio exception.[31] However, stakeholders noted that certain paragraphs of ASC Section 820-10-35, Fair Value Measurement—Overall—Subsequent Measurement, were not updated in 2018 to reflect the change.[32] ASU 2020-03 amends those paragraphs to conform to the previous amendments, clarifying applicability of the portfolio exception to nonfinancial items accounted for as derivatives under ASC 815.[33]

Issue 3: Disclosures for Depository and Lending Institutions. The FASB amended certain paragraphs in ASC Topic 942, Financial Services—Depository and Lending ("ASC 942") to address inconsistencies between ASC 942 and ASC 320, Investments—Debt and Equity Securities ("ASC 320"). Stakeholders noted that the disclosure guidance for debt securities under ASC 942 did not align completely with the guidance in ASC 320.[34] ASU 2020-03 amends paragraphs 942-320-50-3 and 320-10-50-3 to eliminate inconsistencies and clarify that the disclosure requirements in Topic 320 also apply to the disclosure requirements in Topic 942 for depository and lending institutions.[35]

Issue 4: Cross-Reference to Line-of-Credit or Revolving-Debt Arrangements Guidance in Subtopic 470-50. ASC Subtopic 470-50, Debt—Modifications and Extinguishments ("ASC 470-50") provides guidance on modifications and extinguishment of debt. Paragraphs 470-50-40-17 through

28. ASU 2020-03, *supra* note 25, at 1.
29. *Id.* at 8.
30. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-09, Codification Improvements (July 2018) [hereinafter ASU 2018-09].
31. *Id.* at 5.
32. ASU 2020-03, *supra* note 25, at 2.
33. *Id.* at 9.
34. *Id.* at 2.
35. *Id.* at 10–11.

40-18 describe the accounting for fees between debtor and creditor and third-party costs directly related to exchanges or modifications of debt instruments. Paragraph 470-50-40-21 separately describes the accounting for modifications to or exchanges of line-of-credit or revolving-debt arrangements, including fees paid to creditors and third-party costs incurred. Amendments to paragraphs 470-50-40-17 through 40-18 improve the understandability of the guidance by providing a cross-reference to paragraph 470-50-40-21 for fees and third-party costs related to modifications to or exchanges of line-of-credit or revolving-debt arrangements.[36]

Issue 5: Cross-Reference to Net Asset Value Practical Expedient in Subtopic 820-10. ASC Topic 820, Fair Value Measurement ("ASC 820") defines fair value, provides a framework for measuring fair value, and requires certain disclosures about fair value measurements.[37] ASC 820 also allows a reporting entity, as a practical expedient, to estimate fair value using net asset value per share (or its equivalent) for certain investments.[38] Stakeholders requested clarification that the general disclosure requirements for fair value measurements in paragraph 820-10-50-2 do not apply to entities using the net asset value per share (or its equivalent) practical expedient.[39] ASU 2020-03 amends paragraph 820-10-50-2 to provide the suggested clarification.[40]

Issue 6: Interaction of Topic 842 and Topic 326. ASC Topic 326, Financial Instruments—Credit Losses ("ASC 326") requires an entity to estimate credit losses over the contractual term of the asset.[41] Stakeholders noted, however, that the contractual term of the net investment in a lease determined in accordance with ASC 842 (Leases) may not align with the contractual term determined in accordance with ASC 326.[42] Specifically, for purposes of lease accounting, the time period beyond an option to extend the lease may or may not be considered in determining the lease term under ASC 842, depending on the circumstances. ASU 2020-03 amends ASC Subtopic 326-20, Financial Instruments—Credit Losses—Measured at Amortized Cost ("ASC 326-20") to require an entity to use the lease term as the contractual term for net investment in leases recognized by a lessor in accordance with ASC 842.[43] Guidance in ASC 326-20 related to

36. *Id.* at 12–14.
37. *ASC 820*, Fin. Acct. Standards Board, https://asc.fasb.org/ (last visited Feb. 9, 2021) (para. 820-10-05-1).
38. *ASC 820*, Fin. Acct. Standards Board, https://asc.fasb.org/ (last visited Feb. 9, 2021) (paras. 820-10-35-59, 820-10-15-4 through 5).
39. ASU 2020-03, *supra* note 25, at 3.
40. *Id.* at 14.
41. *ASC 326*, Fin. Acct. Standards Board, https://asc.fasb.org/ (last visited Feb. 9, 2021) (para. 326-10-20).
42. ASU 2020-03, *supra* note 25, at 3.
43. *Id.* at 15.

the contractual term for other financial assets will not apply to net investments in leases.[44]

Issue 7: Interaction of Topic 326 and Subtopic 860-20. ASC Topic 860, Transfers and Servicing ("ASC 860") establishes accounting and reporting standards for transfers of financial assets. ASC Subtopic 860-20, Transfers and Servicing—Sales of Financial Assets ("ASC 860-20") addresses sales of financial assets, including recognition guidance.[45] Recognition guidance that applies when an entity regains control of a financial asset previously sold precludes an entity from recognizing a loan loss allowance for loans that do not meet the definition of a security when they are re-recognized.[46] Stakeholders noted that this guidance was not consistent with ASC 326.[47] The amendments to ASC 860-20 remove the prohibition on recognizing a loan loss allowance and clarify that when an entity regains control of financial assets sold, an allowance for credit losses should be recorded in accordance with ASC 326.[48]

Effective dates. The amendments related to Issues 1, 2, 4, and 5 are effective for public business entities upon issuance of ASU 2020-03. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020. Early application is permitted.

The amendment related to Issue 3 affects guidance in the amendments in ASU 2019-04.[49] The relevant effective date of ASU 2019-04 is for fiscal years beginning after December 15, 2019, including interim periods in those fiscal years.

The amendments related to Issues 6 and 7 affect the guidance in the amendments in ASU 2016-13.[50] For entities that have not yet adopted the guidance in ASU 2016-13, the effective date for amendments related to Issues 6 and 7 are the same as the effective date and transition requirements in ASU 2016-13. For entities that have adopted ASU 2016-13, the amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, and should be applied on a modified-retrospective basis.[51]

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44. *Id.*
45. *ASC 860*, Fin. Acct. Standards Board, https://asc.fasb.org/ (last visited Feb. 9, 2021) (para. 860-20-25).
46. *Id.* (para. 860-20-25-13).
47. ASU 2020-03, *supra* note 25, at 3–4.
48. *Id.* at 17.
49. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments (Apr. 2019) [hereinafter ASU 2019-04].
50. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (June 2016) [hereinafter ASU 2016-13].
51. ASU 2020-03, *supra* note 25, at 4–5.

3. Optional Guidance for Reference Rate Reform

In March 2020, the FASB issued ASU No. 2020-04,[52] which provides optional guidance for applying GAAP to contracts, hedging relationships, and other transactions affected by reference rate reform if certain criteria are met. The amendments address stakeholder concerns related to the volume of contracts and other arrangements that will be affected by reference rate reform within a compressed time frame.[53] The amendments also address stakeholder concerns that changes in a reference rate could disallow the application of certain hedge accounting guidance, and certain hedging relationships may not qualify as highly effective during the period of the market-wide transition to a replacement.[54] The optional guidance in ASU 2020-04 is intended to ease the potential burden of accounting for, or recognizing the effects of, the transition from LIBOR to alternative reference rates.[55]

Because of concerns about interbank offered rates, global markets are expected to transition from LIBOR to alternative reference rates by the end of 2021. This transition will require modification of existing contracts and other arrangements that incorporate LIBOR. Under GAAP, such modifications must be evaluated to determine whether they result in the establishment of new contracts or the continuation of existing contracts. ASU 2020-04 allows an entity to apply a simplified accounting analysis for contract modifications that replace a reference rate affected by reference rate reform if certain criteria are met.[56] The amendments provide specific optional expedients for contracts within the scope of the following Topics and Subtopic: ASC Topic 310, Receivables; ASC Topic 470, Debt; ASC Topic 840; ASC Topic 842, Leases; and ASC Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives. For contracts within other Topics or Subtopics, the amendments generally permit an entity to consider modifications for reference rate reform to be an event that does not require re-measurement or re-assessment of a previous accounting determination.[57]

To address stakeholder concerns about the impact of reference rate reform on hedging relationships, the amendments provide exceptions to the guidance related to changes in the critical terms of an existing hedging relationship because of reference rate reform, allowing specified relationships to continue without de-designation under certain specified circumstances[58]:

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52. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-04, Reference Rate Reform (Topic 848) (Mar. 2020) [hereinafter ASU 2020-04].
53. *Id.* at 1.
54. *Id.*
55. *Id.*
56. *Id.* at 2.
57. *Id.* at 3.
58. *Id.* at 3; *see also FASB in Focus, Reference Rate Reform*, Fin. Acct. Standards Board (Mar. 2020), https://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176174308499&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay.

- Certain changes in the critical terms of a designated hedging instrument in a fair value hedge, a cash flow hedge, or a net investment hedge.
- Certain changes to rebalance or adjust the hedging relationship.
- For a cash flow hedge, a change in the method used to assess hedge effectiveness when initially applying an optional expedient method and when reverting to the requirements under current GAAP.

The amendments also provide optional expedients for: hedging relationships for which the component excluded from the assessment of hedge effectiveness is affected by reference rate reform; fair value hedging relationships for which the derivative designated as the hedging instrument is affected by reference rate reform; and cash flow hedging relationships affected by reference rate reform.[59] Additionally, an entity may make a one-time election to sell or transfer, or both sell and transfer, debt securities classified as held to maturity before January 1, 2020, that are affected by reference rate reform.[60]

The amendments are effective for all entities as of March 12, 2020, through December 31, 2022. An entity that elects the optional expedients for contract modifications must apply the optional expedients prospectively for all eligible contract modifications for that Topic or Industry Subtopic within the Codification. An entity may elect optional expedients for hedging relationships on an individual hedging relationship basis. The one-time election to sell or transfer, or both sell and transfer, debt securities classified as held to maturity does not require an entity to transfer all its remaining debt securities that meet the qualifying conditions.[61]

4. Deferral of Effective Dates for Revenues from Contracts with Customers and Leases

In June 2020, the FASB issued ASU No. 2020-05,[62] which delays for certain entities the effective dates of standards for revenue recognition[63] and leases[64] set forth in ASU 2015-04[65] and ASU 2019-10. The updates provided in ASU

59. ASU 2020-04, *supra* note 52, at 3–6.

60. *Id.* at 6.

61. *Id.* at 6–8; *see also FASB in Focus, Reference Rate Reform*, Fin. Acct. Standards Board (Mar. 2020), https://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176174308499&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay.

62. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842) (June 2020) [hereinafter ASU 2020-05].

63. *ASC Topic 606, Revenue from Contracts with Customers*, Fin. Acct. Standards Board, https://asc.fasb.org/ (last visited Feb. 9, 2021) [hereinafter ASC 606].

64. *ASC Topic 842, Leases*, Fin. Acct. Standards Board, https://asc.fasb.org/ (last visited Feb. 9, 2021) [hereinafter ASC 842].

65. Fin. Accounting Standards Bd., Accounting Standards Update No. 2015-04, Compensation—Retirement Benefits (Topic 715) (Apr. 2015) [hereinafter ASU 2015-04].

2020-05 are part of the FASB's commitment to supporting and assisting stakeholders during the difficulty of the COVID-19 pandemic.[66]

The amendments in ASU 2020-05 defer for one year the required effective date of ASC 606 (Revenue) for certain entities that have not yet issued their financial statements reflecting adoption of Revenue. Such entities may elect to adopt the guidance for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020.[67] The FASB deferred the effective dates in response to questions from the franchise industry about revenue recognition of initial franchise fees. The FASB deferred the effective date for franchisors that are not public business entities to explore the issue further.[68] In addition, deferral of the effective dates responds to feedback from private companies and not-for-profit (NFP) entities facing challenges with finalizing their transition to the new guidance due to the COVID-19 pandemic.

Additionally, the amendments in ASU 2020-05 provide a one-year deferral of the ASC 842 (Leases) for certain entities that have not yet issued their financial statements reflecting the adoption of Leases. The FASB noted that challenges associated with transition to a major new standard are often magnified for private companies, smaller public companies, and NFP entities, and those challenges have been significantly amplified by the current business and capital markets disruptions caused by the COVID-19 pandemic.[69] ASC 842 is effective for entities within the "all other" category for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. For public NFP entities that have not yet issued their financial statements (or made financial statements available for issuance) reflecting the adoption of ASC 842, the new standard is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early application continues to be permitted.[70]

5. Improvements to Accounting for Convertible Instruments and Derivatives

In August 2020, the FASB issued ASU No. 2020-06,[71] to improve financial reporting associated with accounting for convertible instruments and contracts in an entity's own equity. The amendments included in ASU 2020-06 simplify accounting for convertible instruments and remove certain conditions that are required for equity contracts to qualify for the derivative scope exception. The ASU also simplifies the diluted earnings per share calculation in certain areas.

66. ASU 2020-05, *supra* note 62, at 1.
67. *Id.* at 4.
68. *Id.* at 2.
69. *Id.* at 3.
70. *Id.* at 4.
71. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-06, Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40) (Aug. 2020) [hereinafter ASU 2020-06].

The FASB noted that these areas of accounting guidance have been a frequent source of financial restatements, and the amendments are expected to improve comparability of information for financial statement users, as well as reducing costs for preparers and auditors.

Convertible Instruments. Prior to the amendments, GAAP provided five accounting models for convertible debt instruments, four of which required that a convertible debt instrument be separated (using different separation approaches) into a debt component and an equity or derivative component. The complexity of these different accounting models was difficult to navigate and resulted in applying or interpreting the guidance incorrectly in some cases, resulting in a significant number of restatements. Moreover, most users of financial statements do not find the current separation models useful and overall would prefer a simple approach to recognition, measurement, and presentation for convertible instruments, with sufficient disclosure.[72]

The amendments in ASU 2020-06 respond to this feedback and simplify the accounting for convertible instruments by removing certain separation models in the relevant Subtopic.[73] As a result of these changes, more convertible debt instruments will be reported as a single liability instrument and more convertible preferred stock will be reported as a single equity instrument. Thus, these changes will provide financial statement users with a more consistent starting point to perform analyses across entities. The amendments also make targeted improvements to the related disclosure guidance to increase transparency.

Derivatives Scope Exception. Under current guidance, an entity must determine whether an equity contract qualifies for a scope exception from derivative accounting.[74] Analysis of the scope exception includes two criteria: (i) the contract is indexed to an entity's own stock (referred to as the indexation guidance); and (ii) the contract is equity classified (referred to as the settlement guidance). If both of these criteria are not met, the contract must be recognized as an asset or liability and potentially accounted for as a derivative. The amendments expand the availability of the derivatives scope exception by removing three of the conditions necessary to qualify for the settlement guidance.[75] As a result of these changes, more equity contracts will qualify for the derivatives scope exception.

Earnings Per Share (EPS). ASU 2020-06 also addresses EPS calculations for convertible instruments and contracts in an entity's own equity. The amendments align the diluted EPS calculation for convertible instruments by requiring that an entity use the if-converted method. The treasury stock method, which currently applies to certain types of convertible instruments, will no longer be used for calculating diluted EPS for convertible instruments.[76] Additionally,

72. *Id.* at 3.

73. *ASC 470-20, Debt—Debt Conversion and Other Options*, FIN. ACCT. STANDARDS BOARD, https://asc.fasb.org/ (last visited Feb. 9, 2021).

74. *ASC 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity*, FIN. ACCT. STANDARDS BOARD, https://asc.fasb.org/ (last visited Feb. 9, 2021).

75. *ASC 815-40-25*, FIN. ACCT. STANDARDS BOARD, https://asc.fasb.org/ (last visited Feb. 9, 2021).

76. ASU 2020-06, *supra* note 71, at 5, BC110.

the amendments require that share settlement be included in the diluted EPS calculation for both convertible instruments and equity contracts when those contracts include an option of cash settlement or share settlement.[77] This change simplifies the guidance by removing an entity's ability to rebut a presumption of share settlement for instruments that have the option to settle in cash or shares and will result in entities including the maximum potential dilution in EPS.[78]

Effective Date. The effective dates for the amendments vary by entity type. For public business entities that meet the definition of an SEC filer, excluding smaller reporting companies, the amendments are effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

6. Improvements to Accounting for Not-for-Profit Entities

In September 2020, the FASB issued ASU No. 2020-07,[79] which improves transparency in the reporting of contributed nonfinancial assets by not-for-profit ("NFP") entities through enhancements to presentation and disclosure requirements. Examples of nonfinancial assets include fixed assets (land, buildings, and equipment), use of fixed assets or utilities, materials and supplies, intangible assets, services, and unconditional promises of those assets.[80] The amendments are intended to address stakeholder concerns about NFP reporting of contributed nonfinancial assets, including a lack of transparency about the measurement of an NFP's contributed nonfinancial assets and the amounts used in an NFP's programs and other activities.[81]

ASC Subtopic 958-605, Not-for-Profit Entities—Revenue Recognition ("ASC 958-605") specifies requirements for the recognition and initial measurement of contributions and disclosure requirements for contributed services, but does not include specific presentation requirements for contributed nonfinancial assets or specific disclosure requirements for contributed nonfinancial assets other than contributed services.[82] ASU 2020-05 updates ASC 958-605 by requiring an NFP to present contributed nonfinancial assets as a separate line item in the NFP's statement of activities. The amendments also require an NFP to disclose the amount of contributed nonfinancial assets, by category, in

77. *FASB in Focus—Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*, Fin. Acct. Standards Board (Aug. 5, 2021), https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176175008979&d=&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay.

78. ASU 2020-06, *supra* note 71, at BC113.

79. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-07, Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets (Topic 958) (Sept. 2020) [hereinafter ASU 2020-07].

80. *Id.* at 1.

81. *Id.*

82. *Id.* at 2.

the notes to financial statements and provide additional disclosures about how contributed non-financial assets were used during the reporting period. Further, an NFP must disclose its policy (if any) and any donor-imposed restrictions related to the use of contributed nonfinancial assets and enhanced disclosure about fair value measurement of such assets.[83]

The amendments in ASU 2020-05 are effective for annual periods beginning after June 15, 2021, and interim periods within annual periods beginning after June 15, 2022. Early adoption is permitted. Once adopted, the amendments should be applied retrospectively to all periods presented in the NFP's financial statements.[84]

7. Improvements to Accounting for Callable Debt Securities

In October 2020, the FASB issued ASU No. 2020-08,[85] which clarifies ASC Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs ("ASC 310-20") as it relates to certain callable debt securities. In 2017, the FASB issued ASU 2017-08[86] to provide guidance on the application of ASC 310-20 and shorten the amortization period for certain purchased callable debt securities held at a premium. Those amendments required entities to amortize the premium for such securities to the earliest call date.[87] The amendments in ASU 2020-08 clarify that an entity should reevaluate for each reporting period whether a callable debt security that has multiple call dates is within the scope of the guidance issued in ASU 2017-08.[88] These clarifications are consistent with the FASB's ongoing Codification improvement project, but the FASB decided to issue a separate update to increase awareness of the amendments and to expedite the improvement process.[89]

For public business entities, the amendments in ASU 2020-08 will be effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early application is not permitted. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. The amendments should be applied by all entities on a prospective basis for existing or newly purchased callable debt securities.[90]

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83. *Id.* at 1–2.
84. *Id.* at 2.
85. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-08, Codification Improvements to Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs (Oct. 2020) [hereinafter ASU 2020-08].
86. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-08, Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities [hereinafter ASU 2017-08].
87. ASU 2020-08, *supra* note 85, at 3.
88. *Id.*
89. *Id.* at 1.
90. *Id.* at 2.

8. Debt—Updates to SEC Sections in the Codification

In October 2020, the FASB issued ASU No. 2020-09,[91] which amends Topic 470 of the Codification (Debt).[92] These amendments update the portions of Regulation S-X included in the SEC Materials section of ASC Topic 470, Debt ("ASC 470")[93] to conform to SEC rule amendments relating to financial disclosure requirements for guarantors, issuers of guaranteed securities, and issuers' affiliates whose securities collateralize securities being registered. The SEC's amendments to Regulation S-X were adopted in March 2020 and take effect on January 4, 2021.[94]

9. Codification Improvements

In October 2020, the FASB issued ASU No. 2020-10,[95] which amended a variety of Topics in the Codification to improve consistency in their application. These amendments are part of the FASB's standing project to address suggestions received from stakeholders and to make other incremental improvements to the Codification that clarify or correct unintended application of the guidance. The update consists of two parts: Section B, which addresses disclosure guidance, and Section C, which contains improvements that vary in nature. Section A, which was included in the 2019 proposed update, was removed from the final update in ASU 2020-10.[96]

Section B of ASU 2020-10 improves the Codification by including in the Disclosure Section (Section 50) for any Topic all guidance that requires or allows an entity to provide information in the notes to financial statements.[97] Where the Codification provides an option to give certain information either on the face of the financial statements or in the notes to the financial statements, the option to disclose in the notes was not always codified in the Disclosure Section. The goal of this update is to reduce the likelihood that the disclosure requirement will be overlooked by reporting entities.[98] The amendments in Section C clarify

91. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-09, Debt: Amendments to SEC Paragraphs Pursuant to SEC Release No. 33-10762 (Oct. 2020) [hereinafter ASU 2020-09].

92. *Accounting Standards Codification 470, Debt*, Fin. Acct. Standards Board, (https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176175008979&d=&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay (last visited Feb. 9, 2021) [hereinafter ASC 470].

93. *ASC Section 470-10-S99*, Fin. Acct. Standards Board, https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176175008979&d=&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay (last visited Feb. 9, 2021).

94. Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities, SEC Release No. 33-10762, 85 Fed. Reg. 21940 (Mar. 2, 2020).

95. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-10, Credit Losses (Topic 326): Codification Improvements (Oct. 2020) [hereinafter ASU 2020-10].

96. *Id.* at 2. The amendments proposed in Section A will be addressed in a separate Accounting Standards Update.

97. *Id.*

98. *Id.*

guidance in a number of different Topics and should improve consistency in how the guidance is applied.[99]

Because the updates do not change GAAP, they are not expected to result in significant changes in practice. However, the FASB included transition guidance to assist entities that may have applied the amended guidance in an inconsistent manner and may need to change their current accounting practices and financial statement reporting. For public business entities, the amendments will become effective for annual periods beginning after December 15, 2020. For all other entities, the amendments will become effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early application of the amendments is permitted. The amendments should be applied retrospectively.[100]

10. Deferral of Effective Date and Early Application for Financial Services Insurance

In November 2020, the FASB issued ASU No. 2020-11,[101] which defers the effective date and provides transition relief for early application of certain targeted improvements to the accounting for long-duration contracts ("LDTI") under ASC Topic 944, Insurance ("ASC 944"). In consideration of the implications of the COVID-19 pandemic on an insurance entity's ability to effectively implement LDTI, ASU 2020-11 defers the LDTI effective date by one year for all insurance entities and provides transition relief to facilitate early application of LDTI.[102]

The FASB issued LDTI on August 15, 2018, to improve, simplify, and enhance financial reporting requirements for long-duration contracts issued by insurance entities.[103] As amended by ASU 2020-11, for public business entities that meet the definition of an SEC filer and are not smaller reporting companies, LDTI is effective for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, LDTI will become effective for fiscal years beginning after December 15, 2024, and interim periods within fiscal years beginning after December 15, 2025.[104] An entity that chooses early application of LDTI may do so at the beginning of the prior year presented or as of the beginning of the earliest period presented.[105]

99. *Id.*

100. *Id.* at 3.

101. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-11, Financial Services—Insurance (Topic 944) (Nov. 2020) [hereinafter ASU 2020-11].

102. *Id.* at 1.

103. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-12, Financial Services—Insurance (Topic 944) (Aug. 2018) [hereinafter ASU 2018-12].

104. ASU 2020-11, *supra* note 101, at 1–2.

105. *Id.* at 2.

B. ASUs Originated by the EITF

Improvements in Accounting for Investments

In January 2020, in response to an EITF consensus, the FASB issued ASU No. 2020-01,[106] which addresses stakeholder questions about the interactions between the measurement alternative provided in ASC Topic 321, Investments—Equity Securities ("ASC 321") and the equity method of accounting in ASC Topic 323, Investments—Equity Method and Joint Ventures ("ASC 323"). Additionally, the update addresses stakeholder questions about the interactions between ASC 321, ASC 323, and ASC Topic 815, Derivatives and Hedging ("ASC 815"). In both cases, stakeholders noted that diverse views have emerged since 2016, when the FASB added the measurement alternative in ASC 321 and made other targeted improvements to address accounting for financial instruments.[107]

The Codification provides different accounting treatment for various forms of investments, including debt securities, equity securities, equity method, and joint ventures.[108] In 2016, the FASB issued ASU 2016-01, which added ASC 321 to provide guidance on the measurement of certain equity securities. ASC 321 includes a measurement alternative for investments without a readily determinable fair value. Under the measurement alternative, an entity can elect to measure those investments at cost, minus any impairment. If an entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, it should measure the equity security at fair value as of the date the observable transaction occurred.[109] The scope of ASC 321 excludes investments accounted for under the equity method in ASC 323 and derivative instruments within the scope of ASC 815.[110]

Following ASU 2016-01, stakeholders noted that diverse views have emerged about application of the measurement alternative and the equity method of accounting.[111] Stakeholders also have noted diverse views about whether certain forward contracts and purchased options to purchase securities should be accounted for under ASC 321, ASC 323, or ASC 815.[112] ASU 2020-01 addresses both of these issues.

Issue 1: Accounting for Certain Equity Securities upon the Application or Discontinuance of Equity Method. ASC 323 provides guidance on the equity

106. Fin. Accounting Standards Bd., Accounting Standards Update No. 2020-01, Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) (Jan. 2020) [hereinafter ASU 2020-01].

107. *See* Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (Jan. 2016) [hereinafter ASU 2016-01].

108. *ASC 323*, Fin. Acct. Standards Board, https://asc.fasb.org/ (last visited Feb. 9, 2021) (para. 323-10-05-1).

109. *Id.* (para. 321-10-35-2).

110. ASU 2020-01, *supra* note 106, at 15.

111. *Id.* at 1.

112. *Id.*

method of accounting, which applies to investments in common stock or in-substance common stock (or both), including common stock of corporate joint ventures. The equity method of accounting applies when an investor has the ability to exercise significant influence over the operating and financial policies of an investee.[113] An increase or decrease in an investment could affect whether that investment is accounted for under the equity method. ASU 2020-01 clarifies that an equity security accounted for in accordance with the measurement alternative should be measured at fair value upon the occurrence of an observable transaction that requires an investor to apply or discontinue the equity method of accounting.[114]

Issue 2: Scope Considerations for Forward Contracts and Purchased Options on Securities. ASC 815 provides guidance on the accounting for forward contracts and purchased options to purchase securities that have certain characteristics. One of those characteristics requires that the contract is entered into to purchase securities that will be accounted for under either ASC 320 or ASC 321.[115] Stakeholders questioned the interaction of the scope guidance in ASC 321, ASC 323, and ASC 815 for forward contracts and purchased options on securities that, upon settlement or exercise, will be accounted for under the equity method of accounting (i.e., ASC 323).[116] ASU 2020-01 clarifies that an entity should not consider whether the underlying securities, upon settlement, would be accounted for under the equity method for purposes of evaluating the characteristics required under ASC 815.[117] The update also clarifies that an entity should not consider whether the underlying securities, upon settlement, would be accounted for under the fair value option in accordance with the financial instruments guidance in ASC Topic 825, Financial Instruments ("ASC 825").[118]

Effective Dates. For public business entities, the amendments in ASU 2020-01 are effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early adoption is permitted for periods for which financial statements have not yet been issued or made available for issuance. The amendments should be applied prospectively at the beginning of the interim period that includes the adoption date.[119]

113. *Id.* at 13.
114. *Id.* at 2.
115. *ASC 815*, Fin. Acct. Standards Board, https://asc.fasb.org/ (last visited Feb. 9, 2021) (para. 815-10-15-141).
116. ASU 2020-01 *supra* note 106, at 16.
117. *Id.* at 2.
118. *Id.*
119. *Id.* at 3.

Caselaw Developments 2020*

Overview

Supreme Court. The Court held that disgorgement is an "equitable relief" that the Securities and Exchange Commission ("SEC" or "Commission") can seek under 15 U.S.C. § 78u(d)(5), but that (i) the liability must be limited to the primary wrongdoer and his or her "partners in wrongdoing" and cannot be extended by open-ended joint and several liability principles; (ii) the amount must be computed by deducting legitimate business expenses; and (iii) the proceeds of the recovery must generally be returned to victims of the wrongdoing, with the Court specifically leaving open whether the SEC may turn over a recovery to the U.S. Treasury in cases where distribution of funds to investors is not feasible.[1]

SEC rulemaking. The D.C. Circuit found the SEC exceeded its authority in adopting Rule 610T, which was designed to "shock" the market and thereby provide data on possible changes in the transaction fees charged by national exchanges and rebates of those fees.[2] The Second Circuit denied a petition challenging Regulation Best Interest, which imposes certain duties on broker-dealers, holding that the Commission had authority to adopt that rule under Dodd-Frank section 913(f).[3] The Second Circuit held that Rule 17a-8 supported an enforcement action by the SEC for a broker-dealer's failure to file appropriate Suspicious Activity Reports, as prescribed by the Financial Crimes Enforcement Network.[4]

In connection with. The First Circuit held that a scheme to embed hidden commissions in charges to clients transitioning portfolios from one asset manager to another was "in connection with" the purchase or sale of securities as Rule 10b-5 uses that phrase.[5] The Ninth Circuit looked to Rule 10b-5 cases to interpret the "in connection with" phrase in 18 U.S.C. § 1348(2).[6]

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* The caselaw developments cover opinions decided in 2020. Where this portion of the annual review expresses opinions, they are those of the author of the caselaw developments, William O. Fisher, and not necessarily the opinions of other authors contributing to the annual review, or of members of the subcommittee producing the review, or of the American Bar Association.

1. *See infra* notes 23–52 and accompanying text.
2. *See infra* notes 56–79 and accompanying text.
3. *See infra* notes 80–94 and accompanying text.
4. *See infra* notes 95–116 and accompanying text.
5. *See infra* notes 119–42 and accompanying text.
6. *See infra* notes 143–54 and accompanying text.

False and misleading representations. The Eleventh Circuit held that a provision in an LLC operating agreement purportedly permitting the CEO to spend invested money in any way he pleased did not provide a defense in a Rule 10b-5 action alleging that he falsely told an investor his money would be spent on projects but in fact used the money to pay the defendant's and others' personal debts.[7] The Second Circuit applied *Omnicare*'s analysis in affirming dismissal of a Rule 10b-5 case in which plaintiffs asserted that the defendants fraudulently predicted revenue from a contract.[8]

Rule 10b-5 duty to disclose. The Second Circuit held that plaintiffs adequately alleged a Rule 10b-5 claim where a REIT said that a major facility operator was making partial monthly rent payments, without disclosing that the REIT had made a $15 million working capital loan to the operator.[9]

Scienter and scienter pleading. Both the Second and Tenth Circuits affirmed dismissal of cases in which Rule 10b-5 plaintiffs relied, principally or in part, on a theory of collective scienter.[10]

Rebutting fraud-on-the-market at class certification. Affirming a class certification, the Second Circuit held that where the plaintiff alleges that the asserted fraud maintained the issuer's stock price, the defendant—in order to rebut the fraud-on-the-market ("FOTM") presumption—must show by a preponderance of the evidence that the entire price decline when the truth came out was due to causes other than the corrective disclosure.[11] Vacating a certification and remanding so that the trial court would consider the defendant's FOTM rebuttal evidence, the Seventh Circuit adopted the Second Circuit protocol requiring a defendant to prove no price impact by a preponderance of the evidence and ruminated on the difficulty of considering price impact evidence without crossing over into consideration of materiality and loss causation.[12]

Loss causation. In reversing a dismissal in part, the Eleventh Circuit held that a complaint pled loss causation by alleging a price decline after an SEC letter to a company sought additional information about two sales metrics and a *Wall Street Journal* article said that the company failed to provide that information; but the court held that a *Wall Street Journal* article about a lawsuit alleging sexual harassment by the company CEO could not constitute a corrective disclosure with respect to alleged false statements about the company's code of ethics because the filings in the harassment case were already public information.[13] Similarly reversing a dismissal in part, and holding that a newspaper story on an SEC investigation constituted a corrective disclosure where plaintiffs alleged fraud by company statements concerning the existence of an investigation, the Ninth Circuit rejected the argument that the story could not qualify as such a disclosure

7. *See infra* notes 158–71 and accompanying text.
8. *See infra* notes 172–78 and accompanying text.
9. *See infra* notes 179–202 and accompanying text.
10. *See infra* notes 203–54 and accompanying text.
11. *See infra* notes 262–92 and accompanying text.
12. *See infra* notes 293–311 and accompanying text.
13. *See infra* notes 317–33 and accompanying text.

because it was based on information obtained by a FOIA request; but the court affirmed dismissal to the extent that the lower court found that a *Seeking Alpha* post was not a corrective disclosure as to assertedly false statements by the company about a whistleblower's complaint because the post failed to provide the market with either new facts or new analysis of facts already known.[14] The Ninth Circuit also found that a whistleblower complaint reported by the *New York Times* could constitute a corrective disclosure where plaintiffs alleged false statements about loan underwriting criteria and Bank Secrecy Act/anti-money-laundering ("BSA/AML") compliance because the whistleblower's complaint alleged hitherto unknown details and identified the plaintiff's position as one in which he would have had access to those details; but affirmed dismissal to the extent that the complaint alleged additional loss causation by a series of *Seeking Alpha* posts authored by anonymous writers who expressly disclaimed any representation of accuracy.[15]

Insider trading. The Second Circuit affirmed the conviction of a principal investigator in a drug trial who traded on information he received about allergic reactions to the drug and the death of one of the trial participants, reasoning that the investigator was a temporary insider within the meaning of *Dirks*' footnote and that, as such, he owed a duty of trust and confidentiality to the drug manufacturer that supported conviction on the misappropriation theory of Rule 10b-5 insider trading.[16]

Proxy statements. The Third Circuit reversed dismissal of a Rule 14a-9 claim insofar as the complaint alleged a failure of the acquiror in a bank merger to adequately disclose the risk that financial regulators would delay the closing because of (i) the acquiror's inadequate BSA/AML compliance and (ii) its practice of converting free checking accounts into fee accounts without customer consent, while affirming dismissal insofar as the claim rested on the acquiror's projection of the closing date and its opinion that it complied with BSA/AML requirements, applying *Omnicare*'s analysis to the prediction and opinion.[17]

Tender offers. The Seventh Circuit affirmed dismissal of a Rule 10b-5 claim where a company repurchased its stock through a Dutch auction and the investors alleged the company misled by announcing, at 8 AM on the morning after the tender offer ended, the preliminary price for the shares based on preliminary figures from the financial company receiving and analyzing the tenders and then announcing, an hour after the close on the same day, the lower final figures; and the court affirmed dismissal of the related Securities Exchange Act of 1934 ("Exchange Act") section 14(e) claim on the basis that an investor cannot use that section to attack a statement made after a tender offer ends.[18]

Life sciences. The Ninth Circuit affirmed dismissal of a Rule 10b-5 claim for the complaint's failure to include facts raising a strong inference of scienter where

14. *See infra* notes 334–56 and accompanying text.
15. *See infra* notes 357–78 and accompanying text.
16. *See infra* notes 379–406 and accompanying text.
17. *See infra* notes 407–37 and accompanying text.
18. *See infra* notes 438–53 and accompanying text.

the plaintiffs contended the manufacturer knew from its device's use in Europe that the Food and Drug Administration ("FDA") would never approve it for sale in the United States.[19] The Second Circuit vacated a dismissal to the extent a Rule 10b-5 claim rested on (i) the defendants' mischaracterization of survival rates in pancreatic cancer studies performed by others and, relatedly, (ii) their stated expectation of survival rates in the control group for the clinical trial the company was performing.[20] The First Circuit affirmed dismissal of a Rule 10b-5 claim for failure to adequately plead scienter where a drug manufacturer stated in 10-Ks that it was "using" current good manufacturing practices ("cGMP") but disclosed a Form 483 raising issues about the manufacturing and stated that those issues would have to be adequately resolved before the FDA would approve a new drug for which the company had submitted a New Drug Application ("NDA").[21] That court also affirmed dismissal of a complaint asserting both Securities Act of 1933 ("Securities Act") section 11 and Rule 10b-5 claims where the company's Registration Statement warned that (i) a patient using the company's exoskeleton walker could be badly hurt or die if the device malfunctioned; (ii) the FDA had approved its use on condition of a post-market surveillance study; and (iii) if the company failed to comply with that condition, the FDA could impose sanctions including seizures and injunctions.[22]

Supreme Court

In 2017, the Supreme Court held that disgorgements in SEC enforcement actions are "penalt[ies]" within the meaning of the five-year statute of limitations in 28 U.S.C. § 2462.[23] In a footnote, the Court left open "whether courts possess authority to order disgorgement in SEC enforcement proceedings [and] . . . whether courts have properly applied disgorgement principles in this context."[24] In *Liu v. SEC*, the Court took up these questions last year.[25]

Mr. Liu had obtained almost $27 million from foreign investors under the EB-5 Immigrant Investor Program that links the use of the investments to investor applications for permanent residence in the United States.[26] The private placement memorandum said that money would be used to fund a cancer treatment center.[27] The district court found, however, that the defendant spent most of the money on "ostensible marketing expenses and salaries," with a "sizable portion" "diverted . . . to personal accounts and to a company under [his wife's] control."[28] The lower court entered an injunction against the defendant and his

19. *See infra* notes 458–91 and accompanying text.
20. *See infra* notes 492–516 and accompanying text.
21. *See infra* notes 517–42 and accompanying text.
22. *See infra* notes 543–58 and accompanying text.
23. Kokesh v. SEC, 137 S. Ct. 1635 (2017).
24. *Id.* at 1642 n.3.
25. Liu v. SEC, 140 S. Ct. 1936 (2020).
26. *Id.* at 1941.
27. *Id.*
28. *Id.* at 1941–42, 1949.

wife, imposed a civil penalty, and "also ordered disgorgement equal to the full amount petitioners had raised from investors, less the $234,899 that remained in the corporate accounts for the project."[29]

The district court ordered that disgorgement under 15 U.S.C. § 78u(d)(5), which provides that "the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors."[30] The Court held that, when "interpreting statutes like § 78u(d)(5) . . . provid[ing] for 'equitable relief,' this Court analyzes whether a particular remedy falls into 'those categories of relief that were *typically* available in equity.'"[31] Applying this rule, Justice Sotomayor (writing for the majority) found that "works on equity jurisprudence reveal two principles"—(i) that "equity practice long authorized courts to strip wrongdoers of their ill-gotten gains" and (ii) that "to avoid transforming an equitable remedy into a punitive sanction, courts restricted the remedy to an individual wrongdoer's net profits to be awarded for victims."[32] She also found that "[e]quity courts . . . generally awarded profits-based remedies against individuals or partners engaged in concerted wrongdoing, not against multiple wrongdoers under a joint-and-several liability theory."[33] Moreover, the "net profits" of which disgorgement stripped the wrongdoer meant "'the gain made upon any business or investment, when both the receipts and payments are taken into the account,'"[34] noting an exception where "the 'entire profit of a business or undertaking' results from wrongful activity," as where the "materials for which expenses were claimed were bought for the purposes of infringement and 'extraordinary salaries' appeared merely to be 'dividends of profits under another name.'"[35]

With the analysis so framed, the Court turned to the defense argument that, since *Kokesh* found SEC disgorgement to be a "penalty" and since equity did not impose penalties, *Kokesh* "effectively decided . . . that disgorgement is . . . not the kind of relief available at equity."[36] Justice Sotomayor responded that "the *Kokesh* Court evaluated a version of the SEC's disgorgement remedy that seemed to exceed the bounds of traditional equitable principles," and therefore said nothing about "the SEC's ability to conform future requests for a defendant's profits to the limits outlined in common-law cases awarding a wrongdoer's net gains."[37]

Constructing the analysis in this way permitted the majority to then observe that, while "the SEC originally endeavored to conform its disgorgement remedy

29. *Id.* at 1942.

30. *Id.* at 1940; 15 U.S.C. § 78u(d)(5) (2018) (quoted language).

31. *Liu*, 140 S. Ct. at 1940 (quoting Mertens v. Hewitt Assocs., 508 U.S. 248, 256 (1993) (emphasis in *Mertens*)). The majority opinion does not identify the time at which what is typical will be judged.

32. *Id.*

33. *Id.* at 1945.

34. *Id.* (quoting Rubber Co. v. Goodyear, 9 Wall. 788, 804, 19 L. Ed. 566 (1870)).

35. *Id.* at 1945–46 (citing and quoting first Root v. Railway Co., 105 U.S. 189, 203 (1882), and second *Goodyear*, 9 Wall. at 803).

36. *Id.* at 1946.

37. *Id.*

to the common-law limitations in § 78u(d)(5)[, o]ver the years, . . . courts have occasionally awarded disgorgement in three main ways that test the bounds of equity practice: by ordering the proceeds of fraud to be deposited in Treasury funds instead of disbursing them to victims, imposing joint-and-several disgorgement liability, and declining to deduct even legitimate expenses from the receipts of fraud."[38] Recognizing that "the parties focused on the broad question whether any form of disgorgement may be ordered and did not fully brief these narrower questions," the majority then vacated the judgment below and remanded for the court of appeals to consider whether these errors infected the disgorgement ordered.[39]

To assist the lower court, the Court provided three comments. First, Justice Sotomayor noted that "[t]he SEC . . . does not always return the entirety of disgorgement proceeds to investors, instead depositing a portion of its collections in a fund in the Treasury" "that . . . may be used to pay whistleblowers reporting securities fraud and to fund the activities of the [SEC's] Inspector General."[40] The SEC argued that any addition to the fund from disgorgement awards was—simply because it resulted from a government enforcement action—"appropriate or necessary for the benefit of investors" within the meaning of 15 U.S.C. § 78u(d)(5).[41] The Court responded that "[t]he equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to wronged investors for their benefit."[42] Although the government suggested that "depositing disgorgement funds with the Treasury may be justified where it is infeasible to distribute the collected funds to investors," the Court saw it as an "open question whether, and to what extent, that practice . . . satisfies the SEC's obligation to award relief 'for the benefit of investors'" and noted "[t]he parties have not identified authorities revealing what traditional equitable principles govern when, for instance, the wrongdoer's profits cannot practically be disbursed to the victims."[43] Since the litigants had not directed the Court's attention to any "specific order . . . directing any proceeds to the Treasury" in *Liu*, Justice Sotomayor simply cautioned that "[i]f one is entered on remand, the lower courts may evaluate in the first instance whether that order would indeed be for the benefit of investors as required by § 78u(d)(5) and consistent with equitable principles."[44]

Second, Justice Sotomayor said that the practice of imposing liability for disgorgement amounts on multiple defendants through joint-and-several liability

38. *Id.*

39. *Id.* at 1947, 1950.

40. *Id.* at 1947; *see* 15 U.S.C. § 78u-6(g)(3)(A)(i) (2018) (monies deposited into the fund include "any monetary sanction collected by the Commission in any judicial or administrative action brought by the Commission under the securities laws that is not added to a disgorgement fund or other fund under section 308 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. § 7246) or otherwise distributed to victims of a violation of the securities laws"); *id.* § 78u-6(g)(2) (money in the fund can be used to "pay[] awards to whistleblowers" or "fund[] the activities of the Inspector General of the Commission").

41. *Liu*, 140 S. Ct. at 1948.

42. *Id.*

43. *Id.* at 1948–49.

44. *Id.* at 1949.

principles was "seemingly at odds with the common-law rule requiring individual liability for wrongful profits" and "could transform any equitable profits-focused remedy into a penalty," but "[t]he common law did . . . permit liability for partners engaged in concerted wrongdoing."[45] Accordingly, the Ninth Circuit on remand should "determine whether the facts are such that [Liu and his wife] can, consistent with equitable principles, be found liable for profits as partners in wrongdoing or whether individual liability is required."[46]

Third, since "courts must deduct legitimate expenses before ordering disgorgement under § 78u(d)(5)," the Ninth Circuit must examine whether some expenses—such as to pay a lease and procure cancer treatment equipment, which "arguably have value independent of fueling a fraudulent scheme"—should be deducted from the disgorgement amount.[47]

Significance and analysis. *Kokesh* and *Liu* express concern that the disgorgement remedy, as currently employed, has exceeded its permissible boundaries. In a somewhat similar vein, the Third Circuit suggested in 2019 that the SEC Enforcement Division has in recent years sometimes sought injunctions that exceed the scope of that equitable remedy.[48] The *Liu* opinion may prompt Commission reexamination of the manner in which the agency frames requests for disgorgement. Alternatively, it could prompt the SEC to propose legislation defining "disgorgement" more broadly, and perhaps also defining the requirements for injunctive relief more liberally.

While *Liu* interprets the statute defining remedies in SEC enforcement actions it brings in federal court, the Commission has the choice of bringing such actions before its administrative law judges.[49] The authorizing statute for administrative proceedings expressly permits the Commission to order disgorgement.[50] The government argued that the addition of this express authority—after the SEC had already begun pursuing disgorgements in federal court that exceeded the Court-identified equitable limits—constituted legislative acceptance of the wide definition that the government sought in *Liu*.[51] Justice Sotomayor responded that "Congress does not enlarge the breadth of an equitable, profit-based remedy simply by using the term 'disgorgement' in various statutes."[52]

45. *Id.*

46. *Id.*

47. *Id.* at 1950. In this eight-to-one decision, only Thomas dissented. *Id.* at 1936. He concluded that disgorgement was not an equitable remedy "available in the English Court of Chancery at the time of the founding" and that the majority had only fit it into traditional equitable remedies by likening it to such remedies with different names. *Id.* at 1950–53 (with quotation from 1953); *id.* at 1951 ("'This Court has never treated general statutory grants of equitable authority as giving federal courts a freewheeling power to fashion new forms of equitable remedies.'" (quoting Trump v. Hawaii, 138 S. Ct. 2392, 2425 (2018) (Thomas, J., concurring))).

48. SEC v. Gentile, 939 F.3d 549, 563–64 (3d Cir. 2019).

49. 15 U.S.C. § 77h-1 (2018).

50. *Id.* § 77h-1(e) ("In any cease-and-desist proceeding under subsection (a), the Commission may enter an order requiring accounting and disgorgement, including reasonable interest.").

51. *Liu*, 140 S. Ct. at 1946.

52. *Id.* at 1947.

This suggests that the limits on disgorgement set out in *Liu* may be applied in administrative actions as well as those in federal court.

Finally, *Kokesh* and *Liu* make an odd pair. Together, they seem to mean that the five-year limitation statute in 28 U.S.C. § 2462 applies to disgorgement, but only when the disgorgement exceeds equitable boundaries. But in those cases the disgorgement itself is improper under *Liu* and no limitations statute need be considered.

Courts of Appeals

SEC rulemaking. The D.C. Circuit held the SEC exceeded its authority in adopting a rule designed to shock the market in order to obtain data on market reaction to three different schemes for caps on transaction fees charged by national exchanges and rebates of those fees, finding the rule insufficiently connected to a regulatory agenda.[53] The Second Circuit denied a petition challenging the SEC's best interest rule for broker-dealers, holding that the Dodd-Frank Act granted the Commission authority to adopt a rule governing broker-dealer obligations to customers in three different subsections, that the SEC was free to choose to use the authority under any one of these, and that the rule the agency adopted fit within the alternative it chose.[54] The Second Circuit also affirmed summary judgment for the Commission in a case challenging SEC authority to bring an enforcement action under Rule 17a-8 based on failure of a broker-dealer to comply with a Treasury regulation requiring broker-dealers to submit Suspicious Activity Reports.[55]

Temporary rule to test effect of changes in national securities exchanges' transaction fees and rebates of those fees. In 2005, the Commission adopted Rule 610, which capped at $0.0030/share the fees that national exchanges can charge for a transaction in equity securities.[56] But most national exchanges offered rebates on the fees.[57] The fee cap and the rebates on those fees generated controversy, with some contending, for example, that rebates created a conflict of interest for broker-dealers as they choose the venue for trade execution[58] and others arguing that the rebates incentivized broker-dealers to provide liquidity for shares and to compete with each other in a way that reduces the bid-ask spread and thereby benefits investors.[59]

To "provide useful data that will better inform future policy recommendations of the effects of fees and rebates on price efficiency,"[60] the SEC adopted in 2019 Rule 610T, which it designed "to produce an exogenous shock that simultaneously

53. *See infra* notes 56–79 and accompanying text.
54. *See infra* notes 80–94 and accompanying text.
55. *See infra* notes 95–116 and accompanying text.
56. 17 C.F.R. § 242.610(c)(1) (2020) (applicable to a quotation of $1 dollar or more).
57. NYSE LLC v. SEC, 962 F.3d 541, 547–48 (D.C. Cir. 2020) [hereinafter *NYSE*].
58. *Id.* at 548.
59. *Id.*
60. Transaction Fee Pilot for NMS Stocks, 84 Fed. Reg. 5202, 5280 (Feb. 20, 2019) [hereinafter SEC 610T Adopting Release].

creates distinct fee environments, each of which restricts transaction-based fees or rebates differently, enabling synchronized comparisons to the current environment for purposes of inferring the existence of causal relationships."[61] Specifically, Rule 610T would have created three groups of equities: 730 subject to a $0.0010/share transaction cap for trades accomplished on national exchanges; 730 subject to the $0.0030/share cap but as to which no national securities exchange could pay a rebate; and all other stocks (the control group) operating under the current $0.0030/share that can be rebated.[62] The constraints in the first two groups would apply to the 1,460 equities traded through the national exchanges, but not to the trades of those same shares through alternative trading systems or other off-exchange venues (e.g., through broker-dealer internal trading systems).[63] About 34 percent of trades flow through those other venues.[64] The rule, a temporary one as signaled by the "T" in its number, would continue for one year, with the Commission having the option to extend it for a second year.[65]

National exchanges and their affiliates petitioned for review of the rule, and the D.C. Circuit granted the petition on the ground that its adoption "exceed[ed the Commission's] authority under the Exchange Act."[66]

The SEC did "not contend that it ha[d] explicit authority" to adopt 610T, but relied on its general rulemaking power under Exchange Act section 23(a)(1) "to make such rules and regulations as may be necessary or appropriate to implement the provisions" of the Act.[67] The Act cabins that general authority by providing that the Commission "shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of [the Act]" and "shall include in the statement of basis and purpose incorporated in any rule or regulation . . . the reasons for the Commission's . . . determination that any burden on competition imposed by such rule or regulation is necessary or appropriate in furtherance of the purposes of this [Act]."[68]

Saying that "[m]erely because an agency has rulemaking power does not mean that it has delegated authority to adopt a particular regulation," the court of appeals characterized Rule 610T as "impos[ing] significant, costly, and disparate regulatory requirements merely to secure information that the Commission may or may not use in the future to determine whether there is a problem worthy of regulation."[69] Although "it is uncontested that Rule 610T would impose

61. *Id.* at 5226 n.304.
62. *NYSE*, 962 F.3d at 545.
63. *Id.*
64. *Id.* at 547.
65. *Id.* at 550.
66. *Id.* at 544–45, 547, 557 (quotation).
67. *NYSE*, 962 F.3d at 553; 15 U.S.C. § 78w(a)(1) (2018). In this regard, the D.C. Circuit contrasted Rule 610T with the Tick Size Pilot, which derived from a statutory mandate for the Commission to study the effect of the then-existing tick size on initial public offerings. *NYSE*, 962 F.3d at 557 (citing 15 U.S.C. § 78k-1(c)(6)).
68. 15 U.S.C. § 78w(a)(2) (2018).
69. *NYSE*, 962 F.3d at 553, 554.

significant burdens on competition,"[70] the Commission had made no "determination that the *regulatory requirements* of the [rule] (as distinguished from its objective of data collection) were[, in spite of the burden on competition,] necessary or appropriate to further the purposes of the Exchange Act."[71] Indeed, the SEC said in its adopting release that it "cannot *ex ante* predict the effects of the Pilot on liquidity and competition between exchanges and off-exchange trading venues for order flow."[72] And the Commission did not identify what possible future substantive regulation Rule 610T was designed to test but simply "expressed the hope that the data . . . would 'inform future regulatory initiatives to the ultimate benefit of investors.'"[73] As the court saw it, the SEC "ha[d] no regulatory agenda (either for the present or the future) supporting the [Rule]; . . . ha[d] taken no position on the conflicting views expressed by members of the regulated community and other commentators regarding the efficacy of the disputed Rule; . . . concededly cannot reasonably assess the effects of the new Rule [610T]; and . . . ha[d] no real idea whether the data collected will be useful or to what end."[74] Accordingly, its adoption of Rule 610T found "no support in the law."[75]

Significance and analysis. One panel member filed a concurring opinion identifying the problem as the SEC's failure "to take the position that there is a problem in its markets before it . . . determine[d] whether [Rule 610T] was an appropriate and necessary step towards a solution."[76] As this concurrence saw it, the study the Commission had made of the differing views about the exchange transaction fees and rebates did not supply the statutorily necessary justification for the rule because the "Commission failed to take a position," "stop[ped] just short of saying whether it believes the critics or defenders of the fee cap have the better case" and accordingly, "without a statement of the agency's position and [regulatory] plan [the court could not] distinguish a valid, nonarbitrary effort to protect investors from an invalid experiment that might at bottom be driven by

70. *Id.* at 553. The court held that the exchanges had standing to bring the lawsuit on the basis that—"[b]ecause the Rule applies only to exchanges"—it "'disadvantages [them] in comparison with ATSs and other off-exchange trading venues with which exchanges directly compete to attract order flow,'" *id.* at 550–51 (quoting the petitioners' brief).

71. *Id.* at 553.

72. SEC 610T Adopting Release, *supra* note 60, at 5281.

73. *NYSE*, 962 F.3d at 550 (quoting SEC 610T Adopting Release, *supra* note 60, at 5244).

74. *Id.* at 555.

75. *Id.* The D.C. Circuit also called 610T "unprecedented." *Id.*

The opinion includes some quotable language, such as "[r]ules are not adopted in search of regulatory problems to solve; they are adopted to correct problems with existing regulatory requirements that an agency has delegated authority to address." *Id.* at 556–57.

After holding that the Commission had no authority to adopt Rule 610T, the D.C. Circuit included a section of its opinion, *id.* at 558–59, devoted to whether the rule was arbitrary and capricious because the SEC failed to provide a reasoned basis for its decision, suggesting that the rule was invalid on this basis as well—largely because the adopting release did not make any finding either that the rule was "'necessary or appropriate in the public interest'" or "about the Rule's effects on efficiency, competition, and capital formation," *id.* at 558. But the court concluded that "it is unnecessary for us to determine" whether the rule violated the arbitrary and capricious standard because "the Commission lacked delegated authority to adopt" it. *Id.* at 559.

76. *Id.* at 560 (Pillard, J., concurring).

little more than academic curiosity—however genuine and intense."[77] The rule was therefore "outside [the SEC's] authority . . . [because the Commission] acted . . . without declaring the problem it perceived with the existing regulatory regime."[78] Put otherwise, "[h]ad [the rationale for 610T] described a hypothesis, identified its specific regulatory relevance, and stated how it could be proved or disproved with the data the Commission hoped to obtain, we would not be accusing the Commission of acting without any 'regulatory agenda' or 'regulatory mission.'"[79]

It is reassuring that the court struck down the Commission's plan to "shock" the market simply to collect empirical data untethered to any specific regulatory action. Sanctioning the rule would have suggested that any agency with general rulemaking power could exercise that authority by ordering different market actors to take different actions for a year or two just to see what would happen. But the concurrence raises the specter that all an agency need do to avoid this result is to collect opinions on two sides of an issue, adopt one side as a working hypothesis (with enough lawyering to justify that choice), and promulgate a temporary rule that the agency would then adopt as a permanent one if the "shock" that it administered to the relevant market suited the agency's taste.

Best interest rule for broker-dealers. The SEC adopted Regulation Best Interest in 2019,[80] requiring broker-dealers to "act in the best interest of the retail customer at the time [a securities] recommendation is made, without placing the financial or other interest of the [broker-dealer] . . . ahead of the interest of the retail customer."[81] Petitioners including an investment adviser challenged the regulation on the grounds that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") required the Commission to promulgate a regulation that imposed the same fiduciary obligations on broker-dealers as are imposed on investment advisers and that the SEC had acted arbitrarily and capriciously in adopting the best interest rule, which does not.[82] The Second Circuit denied the petition.[83]

The DFA included three relevant sections. Section 913(f) provided that the SEC "may commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers . . . , to address the legal or

77. *Id.* at 566–67.
78. *Id.* at 568.
79. *Id.*
80. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318 [hereinafter Best Interest Adopting Release].
81. 17 C.F.R. § 240.15*l*-1(a)(1) (2020). This duty includes requirements that broker-dealers (i) disclose conflicts of interest to customers when making investment recommendations; (ii) have a "reasonable basis to believe that [any given] recommendation is in the best interest" of the customer; (iii) identify and mitigate conflicts of interest and "[p]revent such limitations and associated conflicts of interest from causing the broker, dealer, or [associated] natural person . . . to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer"; and (iv) establish, maintain, and enforce policies and procedures to comply with these obligations. *Id.* § 240.15*l*-1(a)(2)(i)(B), (a)(2)(ii), (a)(2)(iii)(C), (a)(2)(iv).
82. XY Plan. Network, LLC v. SEC, 963 F.3d 244, 247, 253–57 (2d Cir. 2020).
83. *Id.* at 257.

regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to such retail customers."[84] Section 913(g)(1) provided that "the Commission may promulgate rules to provide that, with respect to a broker or dealer, when providing personalized investment advice about securities to a retail customer . . . , the standard of conduct for such broker or dealer . . . shall be the same as the standard of conduct applicable to an investment adviser under section 211 of the Investment Advisers Act of 1940."[85] Section 913(g)(2) said that "the Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers . . . , shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."[86]

The SEC adopted Regulation Best Interest under the first of these sections.[87] And the new regulation, while imposing the best interest standard on broker-dealers when they make investment recommendations to clients, did not require broker-dealers to satisfy all other obligations of investment advisers.[88] The petitioners argued that this violated DFA sections 913(g)(1) and (g)(2), which they contended required the SEC to adopt rules that would equalize the obligations.[89]

The Second Circuit responded that, since each of the three 913 subsections were only permissive (using the word "may"), "Congress gave the SEC the authority to promulgate rules under any of these sections—or to make no rule at all," leaving the Commission free to use the authority under any one of the three, which the Commission did by "cho[osing] to proceed under Section 913(f), not Sections 913(g)(1) or (g)(2)."[90]

Turning to the arbitrary and capricious claim, the Second Circuit found it to rest on two contentions: (i) that Regulation Best Interest "relies on an incorrect interpretation of the broker-dealer exemption to the IAA [Investment Advisers Act]" and (ii) that "the SEC did not adequately address evidence of consumer confusion."[91] As to the first, the court of appeals concluded "that the SEC's

84. Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1827–28 (2010).

85. *Id.* at 1828.

86. *Id.* at 1828–29.

87. *XY Plan. Network*, 963 F.3d at 250 ("The Adopting Release also explicitly noted that the SEC was relying on Section 913(f)[] . . . . [Best Interest Adopting Release, *supra* note 80,] at 33,330.").

88. *Id.* at 255 ("'For example, an investment adviser's fiduciary duty generally includes a duty to provide ongoing advice and monitoring, while Regulation Best Interest imposes no such duty and instead requires that a broker-dealer act in the retail customer's best interest at the time a recommendation is made.'" (quoting Best Interest Adopting Release, *supra* note 80, at 33321 (footnote omitted))).

89. *Id.* at 248.

90. *Id.* at 253. To the rejoinder that this interpretation rendered (g)(2) and (g)(3) superfluous, the court answered that "[s]ection 913(g) is not superfluous because it clarifies that the SEC could have promulgated a uniform fiduciary standard." *Id.*

91. *Id.* at 255. The IAA excludes from its definition of "investment adviser" "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." 15 U.S.C. § 80b-2(a)(11)(C) (2018). The

interpretation of the scope of the broker-dealer exemption is not so 'fundamental' to Regulation Best Interest as to make the rule 'arbitrary, capricious, or otherwise not in accordance with law.'"[92] As to the second, the SEC considered the possibility that the new standard for broker-dealers could cause investor confusion over the differing standards for them and investment advisers, but decided on the less demanding standard for broker-dealers to give customers the option of lower cost with albeit the accompanying lower standard.[93] The Commission having given its reasons for this policy decision, the resulting regulation was not arbitrary and capricious.[94]

Rule imposing broker-dealer obligation to file Suspicious Activity Reports. The Currency and Foreign Transactions Reporting Act of 1970, known as the Bank Secrecy Act ("BSA"), requires the Secretary of the Treasury to propose rules requiring U.S. financial institutions to maintain certain records and report certain transactions.[95] The USA Patriot Act of 2001 amends the Bank Secrecy Act by requiring Treasury to adopt rules—after consulting with the SEC and the Federal Reserve—to mandate that broker-dealers file suspicious activity reports ("SARs").[96] In 2002, Treasury delegated authority to create the regulations under the Patriot Act, and to amend both those and the regulations issued under the BSA, to the Financial Crimes Enforcement Network ("FinCEN").[97] FinCEN adopted what is now 31 C.F.R. § 1023.320 in 2002.[98]

The FinCEN regulation requires broker-dealers to file an SAR for every customer transaction of $5,000 or more that the broker-dealer "knows, suspects, or has reason to suspect . . . (i) [i]nvolves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity . . . ; (ii) [i]s designed, whether through structuring or other means, to evade any requirements of this chapter or of any other regulations

court found that the "Adopting Release contains only a few passing references to the Interpretation [of 'solely incidental'] for the limited purpose of providing regulatory context. *See*, *e.g.*, [Best Interest Adopting Release, *supra* note 80,] at 33,321, 33,336 n.166." *XY Plan. Network*, 963 F.3d at 256 n.9. "And the phrase 'special compensation' is not even mentioned in Regulation Best Interest or the adopting release." *Id.* at 256.

The Second Circuit noted that the Commission had also adopted a rule addressing the interpretation of "solely incidental," which the petitioners had not challenged. *Id.*

92. *XY Plan. Network*, 963 F.3d at 256 (quoting Safe Air for Everyone v. EPA, 488 F.3d 1088, 1101 (9th Cir. 2007) (citation omitted)).

93. *Id.* at 256–57.

94. *Id.* One member of the panel, although "happen[ing] to agree with the majority's analysis of Regulation Best Interest and its rejection of the investment advisers' challenge on the merits," dissented to the extent that the majority found the investment adviser petitioner had standing. *Id.* at 257 (Sullivan, J., concurring in part and dissenting in part).

95. Pub. L. No. 91-508, 84 Stat. 1114 (1970).

96. Pub. L. No. 107-56, § 356(a), 115 Stat. 272, 324 (2001).

97. Treasury Order 180-01; Financial Crimes Enforcement Network, 67 Fed. Reg. 64697 (Oct. 21, 2002).

98. Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations—Requirement that Brokers or Dealers in Securities Report Suspicious Transactions, 67 Fed. Reg. 44048 (July 1, 2002) (adopting release for 31 C.F.R. § 103.19); Transfer and Reorganization of Bank Secrecy Act Regulations, 75 Fed. Reg. 65806, 65808 (Oct. 26, 2010) (renumbering 103.19 to current 1023.320).

promulgated under the [BSA]; (iii) [h]as no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts . . . ; or (iv) [i]nvolves use of the broker-dealer to facilitate criminal activity."[99] A broker-dealer must retain "a copy of any SAR filed and the original or business record equivalent of any supporting documentation for a period of five years from the date of filing the SAR."[100]

Employing its authority under section 17(a) of the Exchange Act, the SEC adopted its Rule 17a-8 in 1981, which says simply that "every registered broker or dealer who is subject to the requirements of the Currency and Foreign Transactions Reporting Act of 1970 shall comply with the reporting, recordkeeping and record retention requirements of chapter X of title 31 of the Code of Federal Regulations."[101] In *SEC v. Alpine Securities Corp.*, the Second Circuit considered (i) whether this regulatory scheme—by which the SEC incorporated Treasury requirements for reporting on certain transactions, including any Treasury changes in those regulations after the Commission promulgated Rule 17a-8—provides authority for the SEC to pursue enforcement actions against broker-dealers for violation of the Treasury SAR regulations; (ii) whether Rule 17a-8 is valid; and (iii) whether adoption of the scheme violated the Administrative Procedure Act.[102]

The SEC had sued Alpine, a broker-dealer, charging that Alpine's failure to file and maintain adequate SARs violated Exchange Act section 17(a)—which provides that every broker-dealer "shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Act]"—and Rule 17a-8.[103] Affirming the district court's summary judgment for the SEC on 2,720 Rule 17a-8 violations, an injunction against further such violations, and a $12 million civil penalty,[104] the Second Circuit rejected the argument that only Treasury is entitled to enforce the SAR requirements, reasoning that Exchange Act section 17(a) and Rule 17a-8 provided the SEC with "independent authority as the primary federal regulator of broker-dealers to ensure that they comply with reporting and recordkeeping requirements of those provisions."[105]

The court similarly rejected the contention that "in authorizing the Treasury to regulate suspicious activity in recordkeeping and reporting by broker-dealers under the BSA, Congress has precluded the SEC from regulating

99. 31 C.F.R. § 1023.320(a)(2) (2020).
100. *Id.* § 1023.320(d).
101. 17 C.F.R. § 240.17a-8 (2020); Recordkeeping by Brokers and Dealers, 46 Fed. Reg. 61454 (Dec. 17, 1981).
102. 982 F.3d 68, 72–73 (2d Cir. 2020).
103. *Id.* at 72; 15 U.S.C. § 78q(a) (2018).
104. *Alpine*, 982 F.3d at 73, 76, 86.
105. *Id.* at 76.

recordkeeping and reporting under the Exchange Act," reasoning that the two statutes and sets of regulations did not conflict.[106] Instead, "Rule 17a-8's incorporation of the BSA's reporting obligation serves the goal of regulatory enforcement by minimizing regulatory costs on broker-dealers, who need only comply with one set of reporting requirements."[107] And "FinCEN's adoption of the SAR regulation in 2002 expressly referenced Rule 17a-8 when it stated that 'both the SEC and SROs [self-regulatory organizations] will address broker-dealer compliance' with the SAR reporting rule," an example of what the court characterized as the two government bodies "work[ing] in tandem."[108]

Responding to Alpine's point that the 2001 Patriot Act specifically directed the Secretary of the Treasury to issue the regulation requiring broker-dealers to file SARs and therefore this legislative action, taken long after the SEC adopted Rule 17a-8, "demonstrates congressional intent for the Treasury to possess sole authority to 'address money laundering and terrorist financing through the compilation of data derived from various financial institutions,'" the court commented that "Congress never proposed to silo SAR *enforcement* authority in the Treasury," and that "Alpine has not met its 'heavy burden' to show that Congress 'clearly expressed [its] intention' to preclude the SEC from examining for SAR compliance in conjunction with FinCEN and pursuant to authority delegated under the Exchange Act."[109]

While Alpine also offered that Rule 17a-8 violated the Administrative Procedure Act because it "permit[ted] the automatic incorporation of future BSA requirements,"[110] the court responded that (i) the SEC adopted its rule after publication and opportunity for comment;[111] (ii) the SEC stated in its proposing release "that it did 'not specify the required reports and records so as to allow for any revisions the Treasury may adopt in the future'";[112] (iii) Treasury adopted 31 C.F.R. § 1023.320 after publication and opportunity for comment;[113] (iv) FinCEN's proposing release "stated that both the SEC and SROs would 'address broker-dealer compliance' with its requirements, including through enforcement actions, as they had done with other BSA recordkeeping and reporting requirements for decades";[114] and (v) "all changes to FinCEN reporting regulations are open to public comment and will be APA[-]compliant whenever such changes

106. *Id.* at 78–79.

107. *Id.* at 78.

108. *Id.* at 78–79 (alteration by the court).

109. *Id.* at 80 (quoting Epic Sys. Corp. v. Lewis, 138 S. Ct. 1612, 1624 (2018) (reciting the standard a litigant must satisfy to show that two statutes cannot be harmonized)).

110. *Id.* at 80 (alteration added).

111. *Id.* at 80–81.

112. *Id.* at 81 (citing here to the adopting release, Recordkeeping by Brokers and Dealers, 46 Fed. Reg. 61454, 61455 (Dec. 17, 1981), but the proposing release contained the same quotation, Recordkeeping by Brokers and Dealers, 46 Fed. Reg. 44775, 44776 (Sept. 8, 1981)).

113. *Id.* at 81.

114. *Id.* (quoting Financial Crimes Enforcement Network; Proposed Amendment to the Bank Secrecy Act Regulations—Requirement of Brokers or Dealers in Securities to Report Suspicious Transactions, 66 Fed. Reg. 67670 (Dec. 31, 2001)).

occur, as happened with the issuance of Section 1023.320."[115] The court specifically "reject[ed] Alpine's argument that the SEC was required to seek future public comments each time FinCEN issue[s] new BSA reporting requirements to avoid an 'improper delegation [to Treasury] of rulemaking authority under the Exchange Act.'"[116]

In connection with. The First Circuit affirmed a Rule 10b-5 conviction of a defendant who engineered a scheme to charge undisclosed commissions to clients transitioning from one asset manager to another, holding that the commissions were in connection with the purchases or sales because they induced the clients to delegate the timing, amounts, and prices of buy/sell decisions to the defendant's firm.[117] In affirming a conviction against a defendant who vouched for language in a press release distributed by a public company, the Ninth Circuit applied Rule 10b-5 cases to interpret the "in connection with" element in 18 U.S.C. § 1348(2).[118]

Undisclosed embedded commissions charged to transition services clients. Exchange Act section 10(b) makes unlawful, "*in connection with the purchase or sale of any security*," "[t]o use or employ . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe," and Rule 10b-5 prohibits false or misleading statements of material fact "*in connection with the purchase or sale of any security*."[119] The First Circuit interpreted this "in connection with" element of a Rule 10b-5 violation in *United States v. McLellan*, affirming the conviction in that case.[120]

The defendant participated in State Street's transition management service, which managed trades by investment pools that were selling and buying assets to rearrange their portfolios when moving from one asset manager to another.[121] State Street offered such services through the agency model by which State Street "act[ed] as an intermediary that facilitate[d] the buying or selling of securities for

115. *Id.* at 83.

116. *Id.* at 81 (alteration in original) (quoting Alpine brief).

The court of appeals found no error in the district court's determination on summary judgment that Alpine had committed the 2,072 SAR violations—"submitting SARs with deficient narratives, failing to submit SARs on deposit-and-sales patterns, and failing to retain support files for SARs." *Id.* at 83. The lower court had relied significantly on (i) "red flags" that the court derived from "the totality of the FinCEN guidance, in the 2002 SAR Form, 2003 Narrative Guidance, and 2012 Instructions," *id.*, as well as (ii) failures "'to include information in SAR narratives that the SAR Form itself directs a broker-dealer to include,'" which Alpine did not contest, *id.* at 84 (quoting SEC v. Alpine Sec. Corp., 354 F. Supp. 3d 396, 419 (S.D.N.Y. 2018), *reconsideration denied*, No. 17CV4179 (DLC), 2019 WL 4071783 (S.D.N.Y. Aug. 29, 2019)). Notably, while the district court judge granted summary judgment on the 2,072 violations, it "denied summary judgment as to hundreds of other alleged violations by Alpine, which the SEC then declined to prosecute further." *Id.* at 76.

The appellate court also found no abuse of discretion in the $12 million civil penalty (which was below the $22.7 million that the SEC requested), given the number of violations and their continuation over years, together constituting "'systematic and widespread evasion of the law.'" *Id.* at 85–86 (quoting Special Appendix).

117. *See infra* notes 119–42 and accompanying text.

118. *See infra* notes 143–54 and accompanying text.

119. 15 U.S.C. § 78j(b) (2018); 17 C.F.R. § 240.10b-5 (2020) (emphasis added).

120. 959 F.3d 442, 449, 457, 476 (1st Cir. 2020).

121. *Id.* at 449.

its clients through a third-party broker-dealer," in exchange for "an upfront flat fee for the entire transition or a disclosed fee per trade."[122] The client investment pool "select[ed] the securities to be sold and bought on the open market."[123]

The defendant's scheme involved telling transition clients that State Street would charge one fee, while planning to add, and then adding, undisclosed commissions that were embedded in the prices—as reported to the clients—of the securities bought and sold.[124]

On appeal from conviction for securities fraud under Rule 10b-5, wire fraud, and conspiracy to commit those crimes,[125] the defendant argued that the evidence was insufficient on the Rule 10b-5 counts to show that the fraud (telling the clients that State Street would charge one fee, while intending to hide a higher fee in reported securities prices) was "in connection with" the trades for those securities.[126] Instead, he argued, the clients made their decisions about what assets they would sell or buy, without regard to the transition fee, but simply to rebalance their portfolios as part of changing asset managers.[127]

In response, the First Circuit held that "even if a client had already made a macro-level decision about the securities it wished to buy or sell before hiring State Street, the micro-level trading decisions that the client delegates to State Street as the transition manager under the agency model—i.e., the choices of when, at what price, and in what quantities to trade—[were] 'decision[s] to purchase or to sell'" within the meaning of the "in connection with" element of a Rule 10b-5 violation.[128] And, the "up-front misrepresentations that [State Street] would not charge commissions were 'material' to those when-and-how decisions because they reasonably induced the clients to delegate those decisions to State Street as their transition manager."[129] Since the evidence showed all this, it was sufficient for the Rule 10b-5 conviction.[130]

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122. *Id.* at 450.

123. *Id.*

124. *Id.* For example, one of the defendant's co-conspirators falsely represented to a Kuwaiti sovereign wealth fund that State Street would conduct transition trades without taking any commissions at all, then this conspirator—in cahoots with the defendant—embedded $2.6 million in undisclosed commissions in the prices for purchases and sales reported to the Kuwaiti fund. *Id.* at 451–52.

125. *Id.* at 448, 455–56.

126. *Id.* at 459.

127. *Id.* ("[The defendant] treats this case as if there is only one investment decision at issue for each transition: the client's macro-level decision that, over some period of time, it would like to transition its investment in Asset X to an investment in Asset Y.").

128. *Id.* at 459–60 (quoting Chadbourne & Parke LLP v. Troice, 571 U.S. 377, 387 (2014)).

129. *Id.* at 460.

130. *Id.* at 460, 465. The court of appeals also found that the trial court's instruction on the "in connection with" element was not so far off true that, in light of the evidence, any error in it justified reversal. *Id.* at 465–67.

While the defendant was located in the United States, his co-conspirators were located in London. *Id.* at 450–51. He argued for reversal of the wire fraud counts, *see supra* note 125 and accompanying text, on the ground that the wire fraud statute does not reach foreign countries and that the trial court erroneously refused to "require[] the jury to find a domestic application of the statute." *Id.* at 467. But the First Circuit determined that the instructions did indeed "require[] the jury to find that [the defendant] utilized a wire in the United States." *Id.* And the wire fraud counts "pinpointed two specific

Significance and analysis. The First Circuit's discussion of the "in connection with" issue wanders over nearly eleven pages.[131] The meanderings include reference to a "'transactional nexus' inquiry" to "determine whether the alleged scheme to defraud and the security transaction are sufficiently close to warrant application of Rule 10b-5."[132] The court also offers that the fraud inducing clients to accept State Street services for one fee while intending to charge a higher one somehow "coincided" with the trades because the "back-end price inflation . . . was necessary to conceal and complete the fraud."[133] And the First Circuit distinguished two Eleventh Circuit decisions holding that fraud causing a client to select a particular broker is not "in connection with" the trades that the broker later executes.[134] In this case, the First Circuit held, the defendant's "misrepresentations concerned the costs of the trades themselves and required [the defendant] to distort the prices of the securities that his firm traded on the back end to conceal (and complete) the fraud."[135]

This discussion illustrates the overcomplicated analysis encrusted onto the "in connection with" element by the Supreme Court and circuit precedents. The transactional "nexus" language is of no help at all, as it leaves open just what kind of nexus must be present. The "coincide" language unfortunately derives from *SEC v. Zandford*, in which the Supreme Court held that the fraud—consisting of a broker making unauthorized transfers to himself from a discretionary account—coincided with securities transactions because "[s]ome of those transfers involved [the broker] writing checks to himself from a mutual fund account held by the [clients], which required liquidating securities in order to redeem the checks."[136] The Court wrote that "[t]he securities sales and respondent's fraudulent practices were not independent events,"[137] and "[i]t is enough that the scheme to defraud and the sale of securities coincide."[138] And, further that "the SEC complaint describes a fraudulent scheme in which the securities transactions and breaches of fiduciary duty coincide."[139]

But that was not true in *McLellan* because the fraud consisted in making the promise that State Street would charge one price for its services while knowing that State Street would not honor the promise.[140] That fraud was complete at the time the knowingly false promise was made.

email communications" between a co-conspirator and the defendant, who worked in Boston. *Id.* at 469 (quotation); *id.* at 451 (defendant's location).

131. *Id.* at 457–67.

132. *Id.* at 458.

133. *Id.* at 460.

134. *Id.* at 461–62 (discussing Brink v. Raymond James & Assocs., Inc., 892 F.3d 1142 (11th Cir. 2018); SEC v. Goble, 682 F.3d 934 (11th Cir. 2012)).

135. *Id.* at 462.

136. 535 U.S. 813, 816 (2002).

137. *Id.* at 820.

138. *Id.* at 822.

139. *Id.* at 825.

140. Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588, 596 (2001).

The better approach would have been to interpret *Zandford* as requiring only that the fraudulent scheme include the purchase or sale of securities by the victim as an integral part, to which the fraud was material—even if the breach of duty does not temporally coincide with the purchase or sale.[141] Perhaps that is what the First Circuit was getting at. It would have been helpful to say so and limit the extra, distracting discussion.[142]

<u>In connection with element in 18 U.S.C. § 1348.</u> Section 1348(2) of Title 18 of the U.S. Code imposes criminal penalties on anyone who "knowingly executes, or attempts to execute, a scheme or artifice . . . to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any . . . security" issued by a public company.[143] The Department of Justice prosecuted the CFO of Autonomy Corporation under this statute after Hewlett-Packard purchased Autonomy and subsequently discovered that Autonomy's revenues were fraudulently inflated prior to the acquisition.[144]

Affirming the CFO's conviction,[145] the Ninth Circuit rejected his contention that the evidence was insufficient because his actions were not "in connection with" any purchase or sale of Hewlett-Packard stock.[146] Not only did the evidence show revenue inflation through a variety of accounting chicanery,[147] but—and this was the basis for the section 1348 charge—the CFO had signed a letter, to which a draft Hewlett-Packard press release announcing the merger and lauding Autonomy's revenue growth was attached, saying "that to the best of his knowledge, 'any information provided by me for inclusion in the Press Announcement . . . is and will be true and accurate in all respects and not misleading in any respect.'"[148] The government called two Hewlett-Packard shareholders who testified that they had bought that company's stock because of the press release's representations of Autonomy's growth and an equity analyst who testified that he used information from the press release to advise investors.[149]

141. In light of *Troice*, the fraud must be material to a purchase or sale made by someone other than the one who committed the Rule 10b-5 violation. In *McLellan*, the purchases and sales were made by State Street's clients because State Street offered transition services on the agency model, with State Street as the agent but the clients as principals, and the trades therefore were attributed to the principals, who had simply "delegate[d the when-and-how] decisions to State Street." *McLellan*, 959 F.3d at 460. The misrepresentations about commissions to be charged were "material" to those trades because "it is well-settled that the price of a security," here inflated by the undisclosed commissions, "is material to a reasonable investor's buy-sell decision." *Id.*

142. But this simpler interpretation might mean that the Eleventh Circuit cases were wrongly decided.

143. 18 U.S.C. § 1348 (2018).

144. United States v. Hussain, 972 F.3d 1138, 1140, 1145 (9th Cir. 2020). The instructions on this count included that "'the scheme was in connection with the purchase or sale of securities of Hewlett-Packard company.'" *Id.* at 1146.

145. *Id.* at 1140, 1148.

146. *Id.* at 1141 ("too attenuated to U.S. securities"); *id.* at 1146.

147. *Id.* at 1141.

148. *Id.* at 1145 (quoting letter).

149. *Id.*

Noting the "scant case law on § 1348," the court of appeals turned to section 10(b) authority, which held that a fraud that "'involves public dissemination in a document such as a press release, annual report, investment prospectus or other such document on which an investor would presumably rely'" satisfies the Exchange Act section 10(b) "in connection with" requirement.[150] Observing that "it can hardly be a surprise—especially to a sophisticated executive like [the CFO]—that investors could and would base their trading decisions" on issuer press releases, the court held that his "assurances that the financial information in the press release was accurate was sufficiently 'in connection with' U.S. securities."[151]

Significance and analysis. Section 1348 includes two subparts. Subsection (1) criminalizes schemes "to defraud any person in connection with any commodity for future delivery, or any option on a commodity for future delivery, or any security" issued by a public company.[152] This first subsection does not mention purchases or sales at all. Subsection (2), which was the one the Ninth Circuit discusses,[153] does use that phrase, criminalizing schemes "to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with *the purchase or sale* of . . . any security" issued by a public company.[154] Accordingly, the Ninth Circuit opinion may not be apposite for interpreting section 1348(1).

False and misleading material representations. The Eleventh Circuit affirmed in 2020 summary judgment for the SEC and found material misrepresentations about how investor money would be used even though the defendant argued that an LLC operating agreement gave him complete discretion to spend that money in any way he chose, including to pay off personal debts.[155] The Second Circuit affirmed dismissal of a case involving revenue projections, holding that

150. *Id*. at 1147 (quoting SEC v. Rana Rsch., Inc., 8 F.3d 1358, 1362 (9th Cir. 1993)).

151. *Id*. at 1147–48. Most of the *Hussain* opinion dealt with whether the other counts—for wire fraud and conspiracy to commit wire fraud—attempted to wrongly apply the U.S. wire fraud statute to actions taken abroad. *Id*. at 1141–42. The Ninth Circuit held that the focus of 18 U.S.C. § 1343 is not the scheme to defraud but "is the use of the wires in furtherance of [that] scheme." *Id*. at 1145. Here "all fourteen counts of wire fraud involved the use of [U.S.] domestic wires in furtherance of the scheme to defraud," with "[s]ix counts stemm[ing] from phone or video conference calls among participants in the United Kingdom and California, five counts focus[ing] on emails originating or terminating in California, and three involv[ing] press releases distributed from England to California." *Id*. Accordingly, "[s]ince each count of wire fraud involved the use of a domestic wire, each conviction is a domestic application of the statute." *Id*.

152. 18 U.S.C. § 1348(1) (2018).

153. *Hussain*, 972 F.3d at 1145. The charging document alleged violation of both § 1348 subsections. Superseding Indictment, United States v. Hussain, No. CR-16-462 CRB, 2017 WL 4865562 (N.D. Cal. Oct. 27, 2017), 2017 WL 7036249, at para. 30. But the lower court's instructions required the jury, in order to convict on the section 1348 charge, to "find Hussain (1) 'knowingly executed or attempted to execute a scheme or plan to defraud or a scheme or plan for obtaining money or property by means of false or fraudulent pretenses, representations, or promises'; (2) 'the statements made or facts omitted as part of the scheme were material'; (3) Hussain 'acted with the intent to defraud'; and (4) 'the scheme was *in connection with the purchase or sale of securities* of Hewlett-Packard company.'" *Hussain*, 972 F.3d at 1146 (emphasis added).

154. 18 U.S.C. § 1348(2) (2018).

155. *See infra* notes 158–71 and accompanying text.

such predictions are opinions subject to *Omnicare*'s analysis to determine whether they are false or misleading.[156]

Statements by CEO about how investor money would be used. The Eleventh Circuit affirmed summary judgment last year for the SEC in a Rule 10b-5/ Securities Act section 17(a)[157] enforcement action against the CEO of Masada Resource Group, LLC ("Masada").[158] The CEO talked an investor into putting $2.15 million cash into the LLC in exchange for three company notes and, in one case, an additional equity interest and 1 percent of profits from a planned facility in Morocco; and, in another case, a promise to pay an additional $100,000 fee "for the convenience of not having to undergo the lengthy commercial banking loan underwriting process."[159] The email solicitation for the first note referred to "an immediate opportunity . . . to secure long-term waste management contracts for a Masada waste-to-ethanol in [*sic*] Morocco . . . [and] a partnership with . . . Mexico's richest man[ ] for Masada contracts and projects in Mexico."[160] The email solicitation for the second note said that, in "gear[ing] up for the anticipated Masada-Waste Management transaction, we will be expending significant sums on [New York], San Francisco, and Atlanta investment bankers and lawyers."[161] The solicitation for the third note said that the money was needed because the CEO had "to cover $600,000 in April and May expenditures related to . . . projects [in Namibia, South Africa, the United Kingdom, the United Arab Emirates, South Korea, and Turkey], including some substantial legal fees for Nabirm relating to the $10 million investment transaction currently being handled by Daniel Stewart & Company in London."[162]

In fact, the CEO directed that the money from the first note be wired to his personal account, with subsequent transfers from that account (i) to repay a previous loan to the LLC and affiliated entities, (ii) to make a payment on the mortgage for the CEO's personal airplane, (iii) to an account used to pay rent and expenses for his girlfriend, and (iv) to pay alimony to his ex-wife.[163] The CEO directed the money from the second note to also be wired to his personal

156. *See infra* notes 172–78 and accompanying text.

157. Rule 10b-5(b) makes it unlawful, in connection with a securities transaction, "[t]o 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." 17 C.F.R. § 240.10b-5 (2020). Section 17(a)(2) makes it unlawful "in the offer or sale of any securities" "to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77q(a)(1) (2018).

158. SEC v. Watkins Pencor, LLC, 810 F. App'x 823, 824, 827, 831 (11th Cir. 2020).

159. *Id.* at 825–27.

160. *Id.* at 825.

161. *Id.* at 826 (second alteration in original).

162. *Id.* (alteration in original).

163. *Id.* at 825–26.

account, with subsequent transfers from that account to (i) his son as a gift, (ii) his ex-wife as alimony, (iii) his girlfriend, (iv) a law firm for work for a company other than Masada, (v) two creditors on personal loans to him, and (vi) the U.S. Treasury for personal tax liability.[164] The money from the third loan was used to pay American Express credit card bills for (i) the CEO, (ii) his son, and (iii) a woman who worked with Masada.[165]

On appeal, the CEO asserted that his representations to the investor were not material because Masada's operating agreement "allowed [him] to use the funds [the investor] loaned him in any manner he chose."[166] Applying the standard legal test, the Eleventh Circuit held that the "misrepresentations were material as a reasonable investor would 'attach importance' to the fact that [the CEO] and Masada used the funds loaned to them to pay for [the CEO's] personal obligations rather than for the lucrative opportunities represented in their emails."[167] And "[e]ven if the operating agreement allowed [the CEO] to spend an investor's money on his personal expenses, it didn't allow him to lie to an investor about the reasons he was asking for money."[168]

The CEO "repackaged" this argument to contend that, "because 'every action' [he and Masada] took was authorized by the Masada operating agreement," the district court wrongly determined there was no genuine material issue as to scienter.[169] Noting that scienter requires either "'knowing misconduct or severe recklessness,'" with the latter applying to "'highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care,'" the court of appeals concluded that "[t]he emails themselves show that [the CEO] and Masada knew or should have known that their misrepresentations presented an obvious danger of misleading [the investor] into believing that they would spend his money for the purposes stated in the emails."[170] And "even if [the CEO] unreasonably believed the operating agreement allowed his lies and deceit, at best his reading would be severely reckless, and he would still be liable under the Securities Act and the Exchange Act."[171]

Revenue projections as opinions under the *Omnicare* analysis. In one other misrepresentation case, a shareholder of Synacor, Inc. brought a Rule 10b-5 case against Synacor and individuals, alleging fraud in defendants' predictions

164. *Id.* at 826.
165. *Id.* at 827 & n.4.
166. *Id.* at 828.
167. *Id.* at 829 (quoting SEC v. Merch. Cap., LLC, 483 F.3d 747, 766 (11th Cir. 2007)).
168. *Id.*
169. *Id.* at 830.
170. *Id.* (quoting first SEC v. Monterosso, 756 F.3d 1326, 1335 (11th Cir. 2014) (quoting SEC v. Carriba Air, Inc., 681 F.2d 1318, 1324 (11th Cir. 1982)); and second, Mizzaro v. Home Depot, Inc., 544 F.3d 1230, 1238 (11th Cir. 2008) (quoting Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1282 n.18 (11th Cir. 1999))).
171. *Id.* at 831.

that a May 2016 web and mobile portal services contract with AT&T would produce $100 million in revenue in 2017 and $300 million in total revenue by 2019.[172] In a disciplined opinion, the Second Circuit affirmed a district court dismissal.[173] Capsulizing the Supreme Court's analysis in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund* ("*Omnicare*"), the circuit court noted three ways in which an opinion (and the "expectations and projections for the future . . . were quintessential opinion statements") can fall afoul of Rule 10b-5: "(1) the speaker did not hold the professed belief, (2) the supporting facts supplied were untrue, or (3) the speaker 'omit[ted] information whose omission ma[de] the statement misleading to a reasonable investor.'"[174] Since the investor affirmatively pled that the executive defendants "'honestly held' their opinions about Synacor's future revenue," the first alternative did not apply.[175] Since the investor only alleged that Synacor omitted facts and since the omitted facts, by definition, could not have been included in the prediction, the second alternative did not apply.[176] As to the alleged omissions—that Synacor "failed to disclose known risks to the achievement of [the] revenue," i.e., "that AT&T prioritized user experience over advertising and controlled monetization decisions, and that the portal might lose users as a result of Synacor's redesign"—the company "publicly stated that it expected to achieve the announced revenue goals only 'after [it] fully deploy[ed] [its] products and migrate[d] AT&T customers'" and made public "a redacted version of the AT&T contract, which [the plaintiffs] themselves characterize[d] as tending to show 'that AT&T controlled monetization.'"[177] Taking these disclosures into account, Synacor did not omit facts rendering its projection misleading to a "'reasonable investor,'" and hence the defendants' statements did not create liability under the third *Omnicare* alternative either.[178]

10b-5 duty to disclose. A Rule 10b-5 claim based on an omission requires that the defendant have a duty to disclose the material fact omitted.[179] That duty can be created, among other ways, by making statements that mislead without

172. Shreiber v. Synacor, Inc., 832 F. App'x 54, 56 (2d Cir. 2020) (summary order).

173. *Id.* at 58 (also approving the lower court's denial of leave to amend on the ground that the amendment would have been futile).

174. *Id.* at 57 (alteration by *Schrieber* court) (citing and quoting Tongue v. Sanofi, 816 F.3d 199, 210 (2d Cir. 2016), in turn referring to Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175, 183, 189 (2015)).

175. *Id.*

176. *Id.*

177. *Id.* at 57–58.

178. *Id.* at 57 (quoting *Sanofi*, 816 F.3d at 210 (quoting *Omnicare*, 575 U.S. at 189)). The Second Circuit observed in a footnote that (i) "the challenged opinion statements regarding future performance were accompanied by meaningful cautionary language specifically addressing the risks alleged to have materialized," (ii) including such language "is statutorily relevant to the safe harbor for forward-looking statements provided in the Private Securities Litigation Reform Act, 15 U.S.C. § 78u-5, but . . . [(iii) such cautions are] also relevant for assessing whether an opinion was misleading by omission" under the *Omnicare* third alternative. *Id.* at 57 n.1.

179. Chiarella v. United States, 445 U.S. 222, 235 (1980) ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.").

disclosure of the fact.[180] The Second Circuit last year found that allegations supported such a duty.

Omega Healthcare Investors, Inc. ("Omega") is a real estate investment trust investing in healthcare facilities.[181] Orianna Health Systems ("Orianna") operated facilities comprising 7 percent of Omega's portfolio.[182] Orianna experienced such severe financial problems in late 2016 and early 2017 that it could not pay its rent.[183] On May 2, 2017, Omega made a $15 million working capital loan to Orianna.[184]

Thereafter, Omega and its executives commented on Orianna repeatedly but failed to disclose the loan.[185] Two days after making the loan, Omega held a conference call with analysts to discuss first quarter results.[186] Omega officers stated that Orianna had experienced "performance pressure" and was forty-five days overdue on its rent, but noted steps that Orianna was taking to address its problems—such as transforming its culture, replacing both senior management and many facility-level managers, selling off some facilities, and rebranding.[187] Specifically addressing a question on Orianna's failure to pay rent, one officer said "that Omega 'feel[s] pretty comfortable that [Orianna is] going to come back with coverages at [its] previous level.'"[188] After the second quarter, while acknowledging in a July 27, 2017 analyst call that Orianna was now ninety days overdue on rent, an Omega officer "explained that . . . Omega was 'consciously [*sic*] optimistic that the combination of . . . [Orianna's] efforts will result in steadily improving margins and eventually return [Orianna] to its former profitability.'"[189] Omega's 10-Q for that quarter disclosed that Orianna "'*is currently making partial monthly rent payments*,'" and repeated that Orianna was replacing management, renegotiating contracts, and selling facilities—leaving Omega "'optimistic that the combination of these efforts will result in improving margins and performance by this operator.'"[190]

At the end of the third quarter, Omega announced in an October 30, 2017 press release that it had placed Orianna on a cash basis—meaning that revenue from this operator would not be recorded on Omega's books when it accrued but

180. 17 C.F.R. § 240.10b-5(b) (2020) (providing it is unlawful "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").

181. Setzer v. Omega Healthcare Invs., Inc., 968 F.3d 204, 207 (2d Cir. 2020).

182. *Id.* at 208.

183. *Id.*

184. *Id.*

185. *Id.* at 208–11.

186. *Id.* at 208.

187. *Id.* at 208–09.

188. *Id.* at 209 (alteration by the court) (quoting joint appendix).

189. *Id.* (all alterations by the court, except last bracketed one, which is added) (quoting joint appendix).

190. *Id.* at 210 (emphasis by the court).

only when it was paid.[191] Omega lowered its own projected 2017 annual numbers "'*to reflect the temporary loss of third and fourth quarter 2017 revenue primarily related to placing Orianna . . . on [that] basis*,'" and confirmed that on an October 31 conference call.[192] The 10-Q for the third quarter reported $20.8 million in impairments on leases to Orianna.[193]

Orianna filed for bankruptcy protection in March 2018.[194] Omega shareholders sued, asserting a Rule 10b-5 claim based on Omega's failure to disclose its $15 million loan to Orianna while Omega and its officers made the statements before October 31.[195]

Reversing the district court's dismissal,[196] the Second Circuit agreed with the plaintiffs that "Defendants were duty-bound to disclose the Loan because the failure to do so rendered statements about Orianna's performance actionably misleading."[197] The defendants said that Orianna was first forty-five days and then ninety days overdue on rent payments, but then said that Orianna was making "partial monthly rent payments."[198] These statements, together, misled by "effectively communicat[ing] that, notwithstanding any disclosures regarding Orianna's performance issues, Orianna could pay more than half of its rent from its earnings," thereby "conceal[ing that] . . . Orianna could not pay rent without borrowing from its landlord."[199]

The court of appeals also held that the complaint adequately alleged facts "rais[ing] a strong inference that Defendants acted, at the very least, recklessly in choosing to disclose incomplete and misleading information regarding Orianna."[200] Since "Orianna's performance plainly impacted Omega's overall financial health; Omega had to know that revealing the full extent of Orianna's performance problems would have been troubling news to its investors."[201] Indeed, "[t]he facts as alleged create a compelling inference that Defendants made a conscious decision to not disclose the Loan in order to understate the extent of Orianna's financial difficulties," particularly in light of comments by analysts who "homed in on Orianna's rental payments being key to Omega's prospects."[202]

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191. *Id.* at 210; *id.* at 209 n.8 (defining cash basis).
192. *Id.* at 211 (emphasis by the court).
193. *Id.*
194. *Id.*
195. *Id.* at 207 (defining class period), 212–13.
196. *Id.* at 207, 216.
197. *Id.* at 213.
198. *Id.* at 214.
199. *Id.* ("On May 4, 2017, Defendants told analysts and investors that, as of March 31, 2017, Orianna was '45 days past due' on its rental payments. Defendants later indicated that, as of June 30, 2017, Orianna was 'approximately 90 days past due on rent payments . . . .'" (record citation omitted)); *id.* at 214 n.14 ("Had Orianna not made any rent payments after March 31, 2017, it would have been 137 days in arrears as of June 30, 2017. Defendants' statements that Orianna was only 90 days past due as of June 30, 2017 conveyed that Orianna had made 47 days' worth of rent payments during the second quarter of 2017—representing payments for over half of the 92-day quarter.").
200. *Id.* at 215.
201. *Id.*
202. *Id.*

Scienter and scienter pleading. To violate Rule 10b-5, the defendant must have acted with scienter, which is either an intent to defraud or severe recklessness.[203] Per the Private Securities Litigation Reform Act ("PSLRA"), a civil plaintiff seeking damages under Rule 10b-5 must plead specific facts giving rise to a "strong inference" of scienter.[204] The facts alleged must support "an inference of scienter" that is "more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[205]

In 2020, the Second and Tenth Circuits addressed whether complaints pled facts to establish that a defendant corporation had scienter.[206] In each case, the plaintiff employed, either as a primary argument or a backup, a "collective scienter" theory. And in each case, the court affirmed dismissal.

Collective scienter as plaintiff's primary theory on appeal. *Jackson v. Abernathy* arose out of a joint effort by Kimberly-Clark Corporation ("KC") and Avanos Medical, Inc. to produce and sell MicroCool medical gowns, designed to prevent "microorganisms, bodily fluids, and particulate matter" being transmitted to medical professionals wearing the gowns, including those treating highly infectious diseases such as Ebola and HIV.[207] Shareholders in both companies sued KC and Avanos, and individual defendants including the KC CEO, alleging violation of Rule 10b-5 by false statements made from August 2014 to April 2016 that the gowns met the Association for the Advancement of Medical Instrumentation ("AAMI") level 4 barrier standard—the highest standard the AAMI defined.[208]

Following district court dismissal for failure to plead facts supporting a strong inference of scienter, the shareholders moved to set aside the judgment and file an amended complaint on the basis of testimony in a California consumer fraud case in which three employees "testified that the MicroCool gown's compliance problems were well known at the companies."[209] On the basis in part of this testimony, "[t]he jury in the California Action found . . . that the companies had intentionally misled consumers about the gown's protective qualities, in violation of California's consumer protection laws."[210]

On appeal of the federal dismissal and denial of the motion to set aside judgment and permit filing of the amended complaint, the plaintiff "abandoned his claims against the Individual Defendants, and argue[d] only that his proposed amended complaint raise[d] a strong inference of scienter against the Corporate

203. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12 (1976); VIII Louis Loss et al., Securities Regulation 9.B.6 & n.555 (6th ed. 2018 & Supp. 2021-1), Wolters Kluwer Cheetah® Securities Treatises.

204. 15 U.S.C. § 78u-4(b)(2)(A) (2018).

205. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

206. *See infra* notes 207–54 and accompanying text.

207. Jackson v. Abernathy, 960 F.3d 94, 96 (2d Cir. 2020).

208. *Id.*

209. *Id.* at 97. The three were: the President of KC's healthcare division, the Director of Global Strategic Marketing for Surgery and Infection Prevention for both companies, and the former Global Director of Surgical and Infection Prevention at KC. *Id.*

210. *Id.*

Defendants" because the new complaint "raise[d] a strong inference of collective corporate scienter."[211] Affirming,[212] the Second Circuit noted that "[w]here a defendant is a corporation," a complaint must "plead[] facts that give rise to 'a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter.'"[213] Since "'the hierarchical and differentiated corporate structure' often muddies the distinction between a deliberate fraud and an unfortunate (yet unintentional) error caused by mere mismanagement,"[214] "most courts look to the discrete roles played by the corporate actors who are connected to the alleged misrepresentation to determine which (if any) fall within the locus of a company's scienter."[215] The easiest way to establish corporate scienter under this scheme "is to impute it from an individual defendant who made the challenged misstatement."[216] But "[t]he scienter of the other officers or directors who were involved in the dissemination of the fraud may also be imputed to the corporation, even if they themselves were not the actual speaker."[217] And, "[i]n exceedingly rare instances, a statement may be so 'dramatic' that collective corporate scienter may be inferred," and the suing "shareholder need not . . . identify the individuals responsible for the fraudulent statement."[218]

Here, the plaintiff failed to "identif[y] any individual whose scienter may be imputed to the Corporate Defendants."[219] The three employees who had testified in the California consumer protection cases "did not themselves possess scienter, as the steps they took to raise concern about the MicroCool gown's testing failures belie any inference of fraudulent intent."[220] Moreover, the complaint failed to include "particularized allegations that senior officers ignored those employees' warnings," which might have shown that those senior officials had scienter.[221] Instead, the plaintiff "offer[ed] only general allegations of warnings

211. *Id.* at 97–98. The Second Circuit summarized the testimony of the three employees so: the President of KC's healthcare division "held a meeting with her team to discuss the MicroCool gown's testing failures." *Id.* at 97. The Director of Global Strategic Marketing for both companies initially stated "that he 'prepared documents for senior [KC] executives that detailed manufacturing problems and resulting product compliance failures,' which were 'presented to senior management, including to [KC's CEO]'" but then "clarified that he did not personally know whether [the CEO] received the presentations about the MicroCool gown's testing failures, but merely assumed that he had." *Id.* KC's former Global Director of Surgical and Infection Prevention "testified that '[the KC CEO] was informed of [the MicroCool gown's] noncompliance issues.'" *Id.* The district court concluded that "the . . . allegations required the court to speculate about what precisely [the KC CEO] was told and whether those warnings were sufficiently obvious as to render [his] inaction reckless" and that "it would have to engage in several layers of speculative inferences to find that [the CEO] (or any other defendant) acted recklessly." *Id.*

212. *Id.* at 99.

213. *Id.* at 98 (quoting Teamsters Loc. 445 Freight Div. Pension Fund v. Dynex Cap. Inc., 531 F.3d 190, 195 (2d Cir. 2008)).

214. *Id.* (quoting Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 707 (7th Cir. 2008)).

215. *Id.*

216. *Id.*

217. *Id.*

218. *Id.* at 98–99 (quoting *Dynex Cap. Inc.*, 531 F.3d at 195–96 (quoting *Makor*, 513 F.3d at 710)). *Makor* used the hypothetical set out in the text accompanying *infra* note 251. *Makor*, 513 F.3d at 710.

219. *Jackson*, 960 F.3d at 99.

220. *Id.*

221. *Id.*

made to unidentified senior executives,"[222] and therefore "provide[d] no connective tissue between those employees and the alleged misstatements."[223] As to whether this case might constitute one of the "exceedingly rare" ones in which top executives are presumed to have knowledge of major problems with a key product, the proposed amended complaint provided only a "naked assertion" that the "MicroCool gown was a 'key product' for the Corporate Defendants," which, "without more, is plainly insufficient to raise a strong inference of collective corporate scienter."[224]

Collective scienter as a backup argument. In *Smallen v. Western Union Co.*, the Tenth Circuit reached a similar conclusion.[225] Western Union ("WU") settled in January 2017 with multiple federal regulators, "agree[ing] to pay $586 million to resolve investigations into the company's [anti-money laundering ("AML")] and anti-fraud programs."[226] Simultaneously, WU "entered into a deferred prosecution agreement ('DPA') wherein the company admitted to willfully failing to implement an effective AML compliance program from 2004 through December 2012."[227] Its stock price fell, and an investor filed a Rule 10b-5 action against the company, the CEO, and two CFOs who served during the class period of February 24, 2012 to May 2, 2017 (the "Class Period"), when the defendants allegedly made false and misleading statements about WU's compliance with AML and anti-fraud laws, as well as other things.[228]

Affirming dismissal,[229] the Tenth Circuit rejected all arguments that the complaint adequately pled scienter. The plaintiff contended that so many red flags appeared—more than 550,000 customer complaints about at least $632,721,044 in fraudulent wire transfers, involving WU agents in several countries, and arrests of third-party agents for fraud and money laundering—that "the Individual Defendants must have known the company's compliance programs were ineffective at the time they made their alleged misstatements."[230] The court of appeals responded that the $632.7 million constituted "less than 1% of the dollars transferred through Western Union's system in 2014 alone, which amounted to $85 billion."[231] More importantly, the complaint failed to "plead any particularized facts either tying the Individual Defendants to the consumer complaints or the agent arrests, or otherwise demonstrating the Individual

222. *Id.* The court of appeals noted that while the plaintiff identified the KC CEO as knowing of the gowns' failures, the plaintiff "chose not to appeal the district court's determination that the proposed amended complaint did not raise a strong inference that [the CEO] acted with scienter." *Id.*

223. *Id.* The court added that it could accordingly "only guess what role those employees played in crafting or reviewing the challenged statements and whether it would otherwise be fair to charge the Corporate Defendants with their knowledge." *Id.*

224. *Id.*

225. 950 F.3d 1297 (10th Cir. 2020).

226. *Id.* at 1303.

227. *Id.*

228. *Id.* at 1302–03.

229. *Id.* at 1302, 1315.

230. *Id.* at 1306.

231. *Id.*

Defendants were aware Western Union's compliance program had failed to redress these issues."[232]

The plaintiff alleged that materials from WU's board and board committee meetings between May 2010 and October 2013 showed "discussions . . . concern[ing] regulators' increased attention to Western Union's agents, the need for improvement in compliance programs to mitigate AML and fraud in high-risk regions, and a competitor's settlement agreement with DOJ."[233] But the Tenth Circuit "fail[ed] to see how either government regulators' increased attention to certain regions or discussions about the need for improving Western Union's compliance controls equates to knowledge of ongoing, unaddressed compliance violations."[234]

The shareholder alleged multiple government investigations of WU's compliance and pointed to the company's SEC filings that described such investigations.[235] While the court said it considered these facts in its "holistic analysis," they would, "standing alone, [be] insufficient to support a cogent and compelling inference of scienter."[236] The shareholder alleged that WU's internal documents analyzed suspicious transactions and agents and showed that WU's compliance program was deficient.[237] But the Tenth Circuit could not find in the complaint "any particularized allegations showing the Individual Defendants themselves dealt with the government regulators, reviewed the underlying documents submitted as part of the investigations, or were otherwise informed legal noncompliance existed within the company during the Class Period."[238]

While the investors pointed to the 2017 settlement and the WU admission in the DPA to having willfully failed to create an adequate AML program, the Tenth Circuit concluded that although the FTC complaint leading to the settlement and the DPA "indicate[d that] some of the company's executives knew about ongoing violations, neither document provide[d] particularized facts tying the Individual Defendants to these violations or otherwise showing they were aware of ongoing illegality and widespread disciplinary failures during the Class Period."[239] Finally, the plaintiffs pointed to stock sales by two of the individual defendants from 2013 to August 2016 as showing a motive to fraudulently inflate the price of WU stock through misstatements during that time.[240] The Tenth

232. *Id.* at 1307.
233. *Id.*
234. *Id.*
235. *Id.* at 1307–08.
236. *Id.* at 1308.
237. *Id.*
238. *Id.* For example, one confidential witness recounted "'regularly brief[ing]'" one of the individual defendants "'on relevant compliance-related issues, including the status of the Southwest Border Agreement and system and compliance changes,'" but neither that witness nor "the other confidential sources cited in the complaint establish that [the executive] reviewed the documents submitted as part of the investigations or was informed about ongoing, unaddressed compliance violations." *Id.* And the complaint included no allegations that either of the other two individual defendants "had any responsibility for compliance matters at Western Union, . . . [or that] any employees reported to them on compliance issues." *Id.* at 1309.
239. *Id.* at 1310.
240. *Id.*

Circuit, however, observed that both of those defendants made the sales "in connection with an exercise of expiring options" and that both of them "increased their aggregate holdings during the Class Period."[241]

Considering all of the scienter allegations together, the court found the benign inference—that "the Individual Defendants neither knew about nor consciously disregarded the ongoing illicit behavior at Western Union when they made their alleged misstatements but rather were overly optimistic about the effectiveness of the company's compliance systems"—was stronger than the malign one—that "the Individual Defendants were aware, at some point during the Class Period, of ongoing illegality not being redressed by Western Union's compliance programs and yet continued to assure investors the company complied with applicable AML and anti-fraud laws."[242] While the individual defendants "failed to give adequate weight to certain red flags, such as pending government investigations, at the time they made their alleged misstatements," this amounted "at most" to "negligence or even gross negligence," but not the kind of "'reckless disregard of a substantial likelihood of misleading investors'" required for the minimum state of mind constituting scienter.[243]

Turning then to WU as a company and the possibility that it might have acted with the requisite state of mind based on the knowledge of executives other than the individual defendants, the panel observed that "[t]he appropriate standard for evaluating whether a non-defendant corporate agent's state of mind can be imputed to a corporate defendant . . . appears to be an open question in this circuit."[244] The Tenth Circuit then expressly rejected the most radical collective scienter argument that the investors made—that "the scienter of *any* Western Union agent, including lower-level corporate officers who played no role in the misstatement, can be imputed to the company for purposes of liability."[245] The PSLRA, in the court's view, forbade such a rule, which would make it "'possible that a company could be liable for a statement made [ ] so long as a low-level employee, perhaps in another country, knew something to the contrary.'"[246] Instead, the Tenth Circuit adopted the Fifth Circuit formula that, to assess the scienter of the company, it would "look to the state of mind of 'the individual corporate official or officials who make or issue the statement

241. *Id.* The complaint did not allege any sales by the third individual defendant and, while it asserted that other executives sold, it "fail[ed] to provide adequate context for these transactions[:] . . . the price initially paid for the stock, what percentage of total shares these sales consisted of, or whether they were buying other types of shares at the same time." *Id.* at 1311. This made it "hard to reach any conclusion as to what kind of financial gain is at issue and whether these sales are unusual or suspicious." *Id.*

242. *Id.* at 1311–12.

243. *Id.* at 1312 (quoting Nakkhumpun v. Taylor, 782 F.3d 1142, 1150 (10th Cir. 2015)); *see id.* at 1305 (describing such recklessness as "akin to conscious disregard").

244. *Id.* at 1312.

245. *Id.* at 1312–13.

246. *Id.* at 1313 (alteration in original) (quoting *In re* Omnicare, Inc. Sec. Litig., 769 F.3d 455, 476 (6th Cir. 2014)).

(or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like)[.]'"[247]

Since the plaintiffs had failed to allege the scienter of the individual executive defendants, they were left under this rule with arguing that other executives had both sufficient guilty knowledge and a sufficient connection with the challenged statements. While one of these, WU's Chief Compliance Officer ("CCO"), allegedly received a report about "a master agent's failure to properly record transactions," that report "indicate[d] the company had already implemented remedial measures to address the issue," and did not show that the CCO had knowledge of "widespread," "ongoing, unremedied illegality."[248] While the complaint alleged that another executive "communicated in June 2010 that efforts were being made to 'save' an agent engaging in fraudulent transactions," that communication was dated some two years before the Class Period began, and WU terminated the agent before the Class Period began.[249] And, although the General Counsel allegedly "'w[as] always briefed on the discipline or shutdown of agents and any related investigations,'" this did not support "an inference—mu[ch] less a strong inference—[that the lawyer] . . . was aware of ongoing, unaddressed illegality within the company."[250] The panel also recognized that some circuits permitted pleading corporate scienter without pleading the scienter of any individual—in special circumstances, for example hypothetically, if "'General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero'"—but said the Tenth Circuit had "neither accepted nor rejected this theory of corporate scienter" and held that it need not address it here because the allegations against WU were "a far cry from [this] hypothetical situation."[251]

Significance and analysis. *Jackson* does not address the most extreme theory of collective scienter, which is just not that the fraudulent *intent* of an employee or officer can be imputed to a corporate defendant but that corporate scienter can be established by showing that individual A within the company made a statement while individual B inside the company knew facts showing that the statement was false.[252] This pure form would surely distort the PSLRA requirement for specific pleading, and *Smallen* expressly rejects it.[253] The more limited standard recounted in *Jackson* only expands the scope of those whose *intent* will be considered to all those who had some significant connection with a statement, as well as permitting a strong scienter inference from a problem of such size and

247. *Id.* (alteration in original) (quoting Alaska Elec. Pension Fund v. Flotek Indus., Inc., 915 F.3d 975, 982 (5th Cir. 2019) (quoting Southland Sec. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 366 (5th Cir. 2004))).

248. *Id.*

249. *Id.* at 1314.

250. *Id.* (first alteration by 10th Cir.) (quoting a confidential witness quoted in the complaint).

251. *Id.* (quoting Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 710 (7th Cir. 2008)).

252. *See* Matt McCabe, *Out on a Limb: Support for a Limited Version of Collective Scienter*, 89 St. John's L. Rev. 939, 952 (2015) ("For example, . . . the statements made by the CEO [could] be matched with the janitor's knowledge of the statement's falsity to satisfy the scienter standard." (footnote omitted)).

253. *See supra* notes 245 and 246 and accompanying text.

importance that it is extremely unlikely to have escaped the notice of the speaker or author. *Smallen* endorses the first part of that more limited approach while declining to accept or reject the second.[254]

Rebutting fraud-on-the-market at class certification. Plaintiffs seeking to certify a class under Rule 23(b)(3) must show "that the questions of law or fact common to class members predominate over any questions affecting only individual members."[255] Since this cannot be done if each member of the putative class has to individually prove reliance by showing that he or she or it actually read or heard the asserted fraud, investors invoke the FOTM presumption—i.e., that the efficient market in which the relevant security traded incorporated the alleged fraudulent misstatement into the price that each investor paid for that security and that each member of the class thereby relied indirectly on the misrepresentation by paying that price.[256]

In 2014, the Supreme Court held that if a class certification motion rests on this theory, the plaintiffs bear the initial burden of showing that the market for the relevant security was generally efficient.[257] Defendants can then attempt to rebut the FOTM presumption by showing that the alleged misstatements in the particular case had no impact on the security's price.[258] In the Second Circuit, such a rebuttal prevails only if defendants show no price impact by a "preponderance of the evidence."[259]

In affirming a class certification, the Second Circuit last year held that, in a price maintenance case, the defendants do not defeat the FOTM presumption on class certification by showing that the alleged misstatements failed to produce a stock price increase and, if they attempt to defeat the presumption by addressing a price decline after a corrective disclosure, they must show by a preponderance of evidence that *no* part of the decline was caused by that disclosure.[260] Vacating a certification because the district court refused to consider the defendant's rebuttal evidence because that evidence also went to materiality—a matter that cannot be litigated at the class certification stage because it is a common question—the Seventh Circuit sent a case back to the lower court to consider the defendant's proof; but in the process (i) provided a

254. In an additional case decided on scienter pleading, the Eighth Circuit affirmed dismissal of a case alleging that officers of a retailer made fraudulent statements about the technology infrastructure, the profitability, and inventory problems at Canadian stores the company had opened. *In re* Target Corp. Sec. Litig., 955 F.3d 738, 740–41, 742, 745 (8th Cir. 2020). The court held that the plaintiffs failed to allege particular facts showing that the executives knew contrary facts at the time they made the challenged statements. *Id.* at 742–43, 744. While the individual defendants had sold 10 to 20 percent of their Target shares during the period of the alleged fraud, the circuit, in a 2002 decision, had "found sales of up to 32% of an individual's stock not inherently suspicious." *Id.* at 743. Moreover, the defendants here had sold most of the shares "early in the class period" and those sales "provide no motive for defrauding investors in the following months." *Id.*

255. Fed. R. Civ. P. 23(b)(3).

256. Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 267–68 (2014).

257. *Id.* at 279.

258. *Id.* at 279–81.

259. Waggoner v. Barclays PLC, 875 F.3d 79, 101–02 (2d Cir. 2017).

260. *See infra* notes 262–92 and accompanying text.

rambling essay on the difficulty in separating the relevance of evidence to the defendant's FOTM rebuttal from the relevance of the same evidence to materiality and loss causation and (ii) joined the Second Circuit by holding "preponderance of evidence" as the standard that defendants must meet in making the rebuttal.[261]

Rebutting the presumption in a price maintenance case. Between 2006 and 2010, Goldman Sachs publicly stated that (i) "[o]ur reputation is one of our most important assets"; (ii) "we increasingly have to address potential conflicts of interest" but "[w]e have extensive procedures and controls that are designed to identify and address conflicts of interest"; (iii) "[o]ur clients' interests always come first"; (iv) "[w]e are dedicated to complying fully with the letter and spirit of the laws, rules and ethical principles that govern us"; and (v) "[o]ur continued success depends upon unswerving adherence to this standard."[262]

Investors who bought Goldman common stock between February 5, 2007 and June 10, 2010 filed a Rule 10b-5 action contending that when Goldman made these statements, it knew that it was acting contrary to the interests of its clients.[263] The shareholders contended that the market learned the truth through (i) an SEC complaint charging Goldman with permitting a short seller to choose securities for a collateralized debt obligation ("CDO") that Goldman sold to its clients (the *Abacus* complaint), with the filing of this complaint followed by a 13 percent decline in Goldman's stock price, and (ii) news released on two later dates that other federal agencies were investigating Goldman about conflicts of interest in other transactions, with each such report followed by an additional decline in Goldman's stock price.[264]

After Goldman moved to dismiss the case on the ground that its statements were not material and the district court denied that motion as to multiple statements on the basis that their materiality could not be decided at the pleading stage, the investors moved to certify a class, and the district court granted that motion.[265] On a Rule 23(f) appeal, the Second Circuit vacated the certification order on the grounds that it was unclear that the district court had applied the preponderance of the evidence standard in evaluating the evidence that Goldman offered in its FOTM rebuttal and erroneously determined that some of that evidence was irrelevant.[266] After remand, the district court granted the motion again after supplemental briefing and an evidentiary hearing.[267]

On a Rule 23(f) appeal of that second certification, the Second Circuit affirmed in 2020.[268] The district court had applied the "inflation maintenance"

261. *See infra* notes 293–311 and accompanying text.
262. Ark. Tchr. Ret. Sys. v. Goldman Sachs Grp., Inc., 955 F.3d 254, 258–59 (2d Cir. 2020), *cert. granted*, 141 S. Ct. 950 (2020) (mem.).
263. *Id.* at 259.
264. *Id.*
265. *In re* Goldman Sachs Grp., Inc. Sec. Litig., No. 10 Civ. 3461 (PAC), 2015 WL 5613150, at *1 (S.D.N.Y. Sept. 24, 2015).
266. *Goldman Sachs*, 955 F.3d at 258, 261–62.
267. *Id.* at 262.
268. *Id.* at 258, 275.

theory of price impact—i.e., that the defendants' statements impacted Goldman's share price "not because they introduce[d] inflation into [the] share price, but because they 'maintain[ed]' it"—a permissible alternative under circuit authority to a claim that defendants' "statements 'introduced' inflation into [the] share price because the market believed them to be true and reacted accordingly."[269] While Goldman argued that the price maintenance theory should apply only where the facts display one of two circumstances—either the issuer misrepresented "specific, material financial or operational information . . . to stop[] a [stock] price from declining"[270] or falsely stated that the company "met market expectations about a specific, material financial metric"[271]—neither of which appeared here,[272] the Second Circuit found its prior authority (like that of the Seventh and Eleventh Circuits) had held "that 'theories of "inflation maintenance" and "inflation introduction" are not separate legal categories'" and "Goldman's proposed rule, by applying only to inflation-maintaining statements," would transform them into separate species.[273] Moreover, the court of appeals interpreted Goldman's argument as an attempt to "smuggl[e] materiality into Rule 23" by limiting price maintenance to specific as opposed to general misstatements because the latter "are, in Goldman's words, 'immaterial as a matter of law,'" even though the Supreme Court has ruled that materiality is not appropriately litigated on a motion to certify a Rule 23(b)(3) class because the materiality of alleged misstatements is a common question for the entire class.[274]

The Second Circuit held that, to apply the FOTM presumption in a case premised on inflation maintenance as opposed to inflation inducement, the plaintiff need not show "proof of fraud-induced inflation."[275] Although the court acknowledged that the price must have been inflated somehow at some time, it suffices for price maintenance that the alleged statements maintained the inflated price, which is satisfactorily demonstrated by showing that the stock price declined after disclosure of the truth about the fraud-maintaining representations.[276] Here, the district court made such a finding—which the Second Circuit reviewed and passed by holding that the lower court did not abuse its discretion—because the trial court expressly "found that '[t]he inflation was demonstrated on [the corrective-disclosure] dates, when the falsity of the

269. *Id.* at 264 (citing *In re* Vivendi, S.A. Sec. Litig., 838 F.3d 223, 257 (2d Cir. 2016)).

270. *Id.* at 266 (alteration in original) (quoting from Goldman's brief, in turn quoting Schleicher v. Wendt, 618 F.3d 679, 683 (7th Cir. 2010)) (internal quotation marks omitted).

271. *Id.* (quoting from Goldman's brief, in turn quoting *In re* Scientific-Atlanta, Inc. Sec. Litig., 571 F. Supp. 2d 1315, 1340–41 (N.D. Ga. 2007)) (internal quotation marks omitted).

272. *Id.*

273. *Id.* at 268.

274. *Id.* at 267 (citing and quoting Amgen Inc. v. Conn. Ret. Plans & Tr. Funds, 568 U.S. 455, 474 (2013); *id.* at 267 n.11 (rejecting the argument that "*Amgen* held only that Rule 23 courts '*need not*' consider materiality, not that they may not do so. To whatever extent *Amgen* is ambiguous, *Halliburton II* is clear that Rule 23 courts *may not* consider materiality. *See* [Halliburton Co. v. Erica P. John Fund, Inc.,] 573 U.S. [258,] 282 [(2014)] ('[M]ateriality . . . should be left to the merits stage, because it does not bear on the predominance requirement of Rule 23(b)(3).' (emphasis added)).").

275. *Id.* at 265 (emphasis and initial capitals omitted).

276. *Id.*

misstatements was revealed'"[277] and "credited [the plaintiffs' expert's] testimony that 'the price declines following these corrective disclosures were caused by the news of Goldman's conflicts.'"[278]

Turning from these matters of concern in all price maintenance cases to the order of proof on the certification motion at hand, the court of appeals noted that Goldman conceded that the plaintiff had satisfied its initial burden by showing that the market for Goldman stock was generally efficient.[279] That meant that the lower court would certify the plaintiff class unless Goldman rebutted the FOTM presumption by a preponderance of the evidence showing its alleged misstatements had not impacted the price of Goldman stock, taking into account plaintiffs' "evidence of price impact to demonstrate the shortcomings of the defendant's rebuttal."[280] To be successful, Goldman's rebuttal required a showing "that the entire price decline on the corrective-disclosure dates was due to something other than its alleged misstatements," and it would be insufficient to simply show that "'another factor *also* contributed to an impact on [the] security's price.'"[281]

Goldman offered rebuttal evidence from two experts.[282] One examined thirty-six instances in which disclosures of Goldman conflicts had no impact on the price of Goldman stock, leading that expert to "conclude[] that the market was indifferent to the news of Goldman's conflicts."[283] The other focused on the facts that the corrective disclosures here (i) announced government actions or investigations, (ii) without simultaneously reporting a resolution with the relevant regulators, and (iii) included both scienter charges and accusations against an individual inside the issuer.[284] This expert found—in announcements of 117 other enforcement actions he studied—only four that displayed all these factors, determined that "[t]he average share price decline following those four enforcement events was 8.07%," calculated that the 9.27 percent decline after the announcement of the SEC *Abacus* complaint was not statistically different from the 8.07 percent, and therefore "opined that the entire price drop was due to the news of the enforcement action, rather than the revelation of Goldman's conflicts."[285]

As to the first Goldman expert, the trial court found that the thirty-six instances of prior disclosures were not comparable to the announcement of the *Abacus* complaint because "'the [*Abacus*] complaint was the first to expose hard evidence of Goldman's client conflicts' by its inclusion of 'direct quotes from damning

277. *Id.* (alteration by the court) (quoting *In re* Goldman, No. 10 Civ. 3461 (PAC), 2018 WL 3854757, at *2 (S.D.N.Y. Aug. 14, 2018)).
278. *Id.* (quoting *Goldman*, 2018 WL 3854757, at *2) (second alteration added).
279. *Id.* at 270.
280. *Id.*
281. *Id.* (quoting Waggoner v. Barclays PLC, 875 F.3d 79, 105 (2d Cir. 2017)).
282. *Id.* at 262–63.
283. *Id.* at 262.
284. *Id.* at 263.
285. *Id.*

emails . . . [and] internal memoranda, disclosing . . . that Goldman had indeed engaged in conflicts to its own advantage,'" and the first defense expert "did not 'credibly explain[ ] how such hard evidence did not contribute to the price decline following the first corrective disclosure.'"[286] As to the second Goldman expert, the trial court noted that (i) he looked only at the announcement of the *Abacus* complaint, not at the rest of the corrective disclosures that the plaintiffs alleged; (ii) his methodology was not "'generally accepted in the field'"; (iii) the four other instances on which he focused "did not involve allegations of mismanagement of conflicts of interest or companies with comparable size or operations to Goldman"; and (iv) his "study did not produce statistically significant results because it looked to the average price decline of only four events (out of a population of 117) with a large variance: declines of 3.34%, 3.73%, 8.13%, and 17.09%."[287] Moreover, the trial court concluded that the sole plaintiff's expert's "'model, at the very least, establishes a link between the news of Goldman's conflicts and the subsequent stock price declines.'"[288]

The Second Circuit held that all of this showed that the trial court had not abused its discretion in holding that Goldman had failed to rebut the FOTM presumption.[289] Along the way, the court of appeals acknowledged that the district court focused on the announcement of the *Abacus* complaint, rather than the other disclosures on which the plaintiffs purportedly relied that did not include the detailed "hard evidence" the lower court found so important, but held that "[t]he burden of rebutting the [FOTM] presumption was on Goldman, not the district court. The court's finding that the Abacus disclosure had a price impact suffices at this stage."[290] And the Second Circuit emphasized that "'[t]he best way to determine the impact of a false statement is to observe what happens when the truth is finally disclosed and use that to work backward, on the assumption that the lie's positive effect on the share price is equal to the additive inverse of the truth's negative effect.'"[291] That, as the Second Circuit saw it, was "precisely what the district court did" when it concluded that the plaintiff's

286. *Id.* at 262–63 (quoting *Goldman*, 2018 WL 3854757, at *5).

287. *Id.* at 263 (quoting *Goldman*, 2018 WL 3854757, at *5). Venturing into econometric intricacies, the trial court also "faulted [this expert's testimony] for comparing the Goldman price decline to the four events using a two-sample t-test, which some authorities have explained 'is not appropriate for small samples drawn from a population that is not [statistically] normal.'" *Id.* (quoting *Goldman*, 2018 WL 3854757, at *6).

288. *Id.* at 272 (quoting *Goldman*, 2018 WL 3854757, at *4).

289. *Id.* at 274. The court of appeals figured that if Goldman had "disclosed its alleged failure to prevent employees from illegally advising clients to buy into CDOs that were built to fail by a hedge fund secretly shorting the investors' positions," it was "reasonable to assume" that some customers would have decided not to "trust[] Goldman with their money," which would have reduced Goldman's revenue and therefore its share price—all this having "nothing to do with the threat of enforcement actions, and everything to do with how Goldman managed its conflicts of interest." *Id.* at 271–72.

290. *Id.* at 272.

291. *Id.* at 273 (quoting *In re* Vivendi, S.A. Sec. Litig., 838 F.3d 223, 255 (2d Cir. 2016) (quoting Glickenhaus & Co. v. Household Int'l, Inc., 787 F.3d 408, 415 (7th Cir. 2015))).

expert, "'at the very least, establish[ed] a link between the news of Goldman's conflicts and the subsequent stock price declines.'"[292]

Significance and analysis. *Goldman* demonstrates that a defendant seeking to rebut the FOTM presumption on class certification faces significant difficulties if the plaintiff is proceeding on a price maintenance theory. The plaintiff need only show that the subject security traded in a generally efficient market, need not show that any of the defendants' statements caused the stock to rise, and thereby prevails at class certification unless the defendants can show by a preponderance of the evidence that 100 percent of the stock price decline after the plaintiffs' asserted corrective disclosures was due to factors other than the revelation of the supposed truth. The Supreme court granted certiorari in *Goldman*, and may clarify.

Limiting the price impact analysis to permissible bounds. In a Rule 10b-5 action, investors alleged that after Allstate announced in 2013 that it would attempt to increase the number of its automobile insurance customers "by 'softening' its underwriting standards," the company then falsely characterized "claim frequency trends [as] 'extremely favorable'" when in fact claims were increasing, and later falsely attributed the increase to "factors such as higher-than-usual precipitation and miles driven rather than the actual cause, the company's growth strategy of taking on riskier business."[293] When the company disclosed on August 3, 2015 that the growth strategy was responsible at least in part and that Allstate "was 'tightening some of [its] underwriting parameters,'" its stock price declined by over 10 percent.[294] The district court certified a Rule 23(b)(3) class in the case, and the Seventh Circuit granted defendants interlocutory review under Rule 23(f).[295]

The appellate court recognized that certification of a Rule 23(b)(3) class in a securities class action under Rule 10b-5 requires that "a plaintiff must show the ability to use common evidence of reliance, i.e., to use the *Basic* [FOTM] presumption."[296] Here, "plaintiffs offered evidence that Allstate stock trades in large, public, efficient markets, so that any false information defendants introduced into the market could be presumed to have been baked into the market price for Allstate stock."[297]

But the defendants had the right to rebut the FOTM presumption, which may be done by "direct evidence demonstrating that the alleged misrepresentations

292. *Id.* (quoting *Goldman*, 2018 WL 3854757, at *4).

The panel hearing the Goldman appeal split two-to-one. The dissenter observed that the plaintiff's expert "offered no clear explanation for why the market only moved after the 37th recital of fraud allegations." *Id.* at 277 (Sullivan, J., dissenting). While conceding that Goldman had the burden of proof after the plaintiff established the general efficiency of the market in which its shares traded, *id.*, he worried that "[i]f such evidence can be neutralized by the mere assertion that the SEC's repackaging of those disclosures must have 'at least contribute[d] to the stock price declines,' *In re Goldman*, 2018 WL 3854757, at *4, then the *Basic* presumption is truly irrebuttable and class certification is all but a certainty in every case." *Id.* at 278.

293. *In re* Allstate Corp. Sec. Litig., 966 F.3d 595, 601 (7th Cir. 2020).

294. *Id.*

295. *Id.* at 600, 602.

296. *Id.* at 605.

297. *Id.* at 602.

had no impact on the stock price."[298] The Seventh Circuit joined the Second in holding that, when a defendant attempts such a rebuttal, the defendant must do so by a "preponderance of evidence, taking into account plaintiffs' . . . reports and additional evidence challenging [the defendant's] showing."[299]

Importantly, however, the same evidence that goes to price impact can be relevant not only to reliance based on the FOTM presumption but also to materiality and loss causation.[300] Since Supreme Court authority expressly holds that a plaintiff need not show either materiality or loss causation in order to obtain class certification,[301] "a district court deciding class certification [must] (a) decide whether reliance can be proven by common evidence without (b) delving too far into the merits of the materiality or falsity of the representations at issue, while still (c) reserving loss causation entirely for the merits phase."[302]

Here, Allstate's expert (i) "found no statistically significant increase in Allstate's stock price following any of the alleged misrepresentations."[303] She also opined (ii) that the alleged misstatements could not have affected Allstate's stock price because "'the fact that the Company's growth strategy was expected to cause higher claims frequencies, was publicly disclosed in the Company's conference calls prior to the alleged Class Period, was covered in analyst reports on the Company published prior to and at the beginning of the alleged Class Period and, in an efficient market, would have already been impounded into Allstate's stock price.'"[304]

As the Seventh Circuit reasoned, this expert's "finding that a lack of price reaction after the nine statements at issue indicates that they had no price impact does not actually resolve the legal issue of price impact" because the plaintiffs contended that the misstatements maintained Allstate's stock price, and in such a case the "best evidence available" of price impact is the corrective disclosure and the "ensuing price drop."[305] This left the defendants with their expert's second finding, which was that Allstate acknowledged from the get-go that its growth strategy risked increased claims, the market knew that before August 3, 2015, and therefore the market could not have reacted to a subsequent revelation that claims had in fact increased after the company sold policies to worse drivers.[306]

The trial court had ruled that Allstate's arguments, *in toto*, would have the court improperly rule on merits issues.[307] While the Seventh Circuit agreed "that Allstate's price impact theory looks very much like the prohibited defenses

298. *Id.* at 609.
299. *Id.* at 610–11 & n.4 (omitting citation to Ark. Tchrs. Ret. Sys. v. Goldman Sachs Grp., Inc., 879 F.3d 474, 485 (2d Cir. 2018)).
300. *Id.* at 604–05.
301. *Id.* at 606–07.
302. *Id.* at 608.
303. *Id.* at 611.
304. *Id.*
305. *Id.* at 612 & n.5.
306. *Id.* at 613.
307. *Id.* at 602.

of no materiality or 'truth on the market,'" it held that "the close similarity does not allow a district court to avoid a price impact defense at the class certification stage,"[308] vacated the class certification order, and remanded for the lower court to further consider the "evidence relevant to price impact."[309] Oracularly, the Seventh Circuit offered the "guidance" that "the district court must then make findings needed to decide class certification while resisting the temptation to draw even obvious inferences on topics that are forbidden at this stage: materiality and loss causation. The court must assess evidence that may speak directly to the forbidden merits inquiries of materiality and loss causation, while evaluating it only for what it reveals about the core *Basic* inquiry of transaction causation."[310]

Significance and analysis. This windy and rambling opinion, with a disturbingly "isn't this interesting" academic note to it, provides little practical guidance to district courts, except that they should be wary of categorically rejecting defense evidence on price impact just because that evidence also goes to materiality, loss causation, damages, or other elements. The opinion, however, wrongly suggests that district court judges will have to exercise extraordinary acumen to limit their consideration of econometric evidence to price impact. Litigants often present a piece of evidence that is relevant to multiple elements, and courts regularly then analytically isolate the impact of that evidence on each element at issue. District judges should have no more trouble isolating their consideration of financial evidence to price impact than in the many other instances in which they must perform similar mental compartmentalization.

Most of the Seventh Circuit's concern stems from the second finding of Allstate's expert.[311] Considering that evidence in particular, *Allstate*, like *Goldman*, illustrates the difficulty defendants face in defeating class certification by a price impact rebuttal in a price maintenance case.

Loss causation. A Rule 10b-5 plaintiff must plead and prove that the challenged statements or omissions caused that plaintiff economic loss.[312] Commonly, though not exclusively, plaintiffs show loss causation in open market cases by pleading and then proving that one or more corrective disclosures revealed the false or misleading nature of the defendants' statements, and that a decline in the market price of the issuer's stock quickly followed each such corrective revelation.[313]

308. *Id.*

309. *Id.* at 609.

310. *Id.* at 611. The district court reviewed the evidence on remand, concluded that the defendants had not rebutted the FOTM presumption, and again granted class certification. *In re* Allstate Corp. Sec. Litig., No. 16 C 10510, 2020 WL 7490280 (N.D. Ill. Dec. 21, 2020).

311. *See* text at *supra* note 304.

312. 15 U.S.C. § 78u-4(b)(4) (2018); Dura Pharms. Inc. v. Broudo, 544 U.S. 336, 342 (2005).

313. *Dura Pharms.*, 544 U.S. at 344 ("[T]he Restatement of Torts, in setting forth the judicial consensus, says that a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains 'when the facts . . . become generally known' and 'as a result' share value 'depreciate[s].' § 548A, Comment *b*, at 107.").

In 2020, the Eleventh Circuit reversed dismissal of a Rule 10b-5 claim insofar as it rested on allegedly misleading statements about two sales metrics that an issuer touted, holding that the complaint sufficiently pled loss causation by price drops after the SEC by letter sought additional information about the metrics and the *Wall Street Journal* published an article saying that the company failed to provide that information; but the court affirmed dismissal of the claim insofar as it rested on the company's touting its code of ethics prohibiting harassment, holding that the complaint failed to plead loss causation despite alleging a price decline after the *Wall Street Journal* ran a story on a harassment lawsuit, with the court reasoning that the article did not disclose new information to the market over and above the publicly accessible filings in the harassment case.[314] The Ninth Circuit reversed a Rule 10b-5 dismissal insofar as investors pled that a company misled investors as to the existence of an SEC investigation, finding that the complaint adequately alleged loss causation by a price drop following a newspaper story on the investigation, despite the fact that the story resulted from information obtained by a FOIA request, the panel reasoning that just because information is obtainable through such a request, it is not in the market until (i) a request is made for it, (ii) the information is provided in response to the request, and (iii) the recipient then publicizes the information to the market; but the court affirmed dismissal insofar as the plaintiffs alleged that the defendant company commented falsely on a whistleblower's complaint, holding that a post on *Seeking Alpha*—which the plaintiffs contended revealed the truth of the whistleblower's charges—neither included new facts nor provided an analysis of already public facts that required expertise or skill beyond that possessed by market participants.[315] In a different case in which the plaintiffs asserted that a bank misleadingly characterized its loan underwriting and BSA/AML compliance, the same circuit held that plaintiffs satisfactorily alleged loss causation by pleading that the bank's stock price fell after a whistleblower filed a complaint that was reported in the *New York Times* because, though the complaint contained only allegations, it provided details and identified the plaintiff as one who was in a position to know those details; but the court also held that blog posts on *Seeking Alpha* were not corrective disclosures because (i) they were "authored by anonymous short-sellers," (ii) relied on ostensibly public information, and (iii) stated that the authors made "no representation as to the accuracy or completeness of the information."[316]

<u>SEC letter to company and later *Wall Street Journal* article as corrective disclosures.</u> National Beverage Corporation ("National Beverage") sold sparkling waters.[317] In 2017, the company "issued several press releases discussing how the Company 'utilize[s] two proprietary techniques to magnify [VPO, or velocity per outlet, and VPC, or velocity per capita,] and this creates growth never before

314. *See infra* notes 317–33 and accompanying text.
315. *See infra* notes 334–56 and accompanying text.
316. *See infra* notes 357–78 and accompanying text.
317. Luczak v. Nat'l Beverage Corp., 812 F. App'x 915, 917 (11th Cir. 2020).

thought possible,'" and stated "that an 'impressive VPO calculator that was reflected on the cover of our fiscal year 2015 Proxy is flashing solid green numbers as we bring FY2017 to a close.'"[318] When the SEC asked National Beverage to either discuss these measures or state why it concluded that it did not need to do so, the company "responded by refusing to disclose the basis for VPO and VPC, which it said were 'proprietary methods,' [and by saying that] these metrics 'are used to establish goals for certain customers, but are not utilized to manage the overall executional side of [its] business.'"[319] Seeing a contradiction between this response and the press releases, the Commission asked the company by a March 23, 2018 letter for "'an expanded response that explains the VPO and VPC metrics and reconciles [these statements] with the statement that VPO and VPC are not utilized to manage your business and are not key performance indicators.'"[320] National Beverage's stock price declined by $4.82 the next day, to close at $82.83.[321] After the *Wall Street Journal* published an article on June 26 reporting "that 'National Beverage declined to provide the requested figures' regarding these metrics to the SEC," the share price lost $9.75 the following day.[322]

In an unrelated matter, the *Wall Street Journal* reported on July 3, 2018, "that two private-jet pilots accused [the National Beverage CEO and owner, who controlled over 70 percent of the company's common stock,] of inappropriately touching them during more than 30 trips between 2014 and 2016."[323] Two trading days later, the National Beverage stock price lost $2.90.[324]

A shareholder filed a Rule 10b-5 suit against the company, the CEO, and the Executive Vice President of Finance, alleging that the company's statements about VPO and VPC misled and that the company failed to disclose the CEO's sexual misconduct even as it was touting in its 10-Ks that its code of ethics "'absolutely prohibited'" "'[a]ny type of harassment, whether of a racial, sexual, or other nature.'"[325] After the district court dismissed the action on the grounds that the plaintiff did not allege loss causation, the Eleventh Circuit reversed as to the VPO/VPC claim but affirmed as to omissions of sexual harassment.[326]

Concerning the asserted fraud by the press releases referring to VPO and VPC, the court of appeals "agree[d] with [the shareholder] that the district court failed to analyze his complaint as alleging a series of partial disclosures" by unduly concentrating on the March 23 SEC letter alone and finding that that letter did "not constitute either 'proof of fraud' or 'proof of liability.'"[327] Since the plaintiff

318. *Id.* at 921–22.
319. *Id.* at 921.
320. *Id.* at 922 (alteration by court) (quoting SEC letter).
321. *Id.* at 918.
322. *Id.*
323. *Id.* at 917, 918.
324. *Id.* at 918.
325. *Id.*
326. *Id.* at 926–27.
327. *Id.* at 922 (one layer of internal quotation marks omitted) (quoting Luczak v. Nat'l Beverage Corp., 400 F. Supp. 3d 1318, 1330 (S.D. Fla. 2019) (quoting Sapssov v. Health Mgmt. Assocs., Inc., 608 F. App'x 855, 863 (11th Cir. 2015))).

"allege[d] the March 23 letter and the June 26 article cumulatively disclosed National Beverage's allegedly fraudulent practices," he did not "need to allege the March 23 letter alone show[ed] proof of fraud."[328] Considering the letter and the article together, the court of appeals concluded that the complaint successfully "alleges the defendants' fraudulent behavior leaked out through a series of partial disclosures, causing a drop in the stock price."[329]

The Eleventh Circuit, however, added that the district court misanalyzed the March 23 letter by itself because, as the SEC "had already requested sales information" before that letter "and explained it was having difficulty 'reconcil[ing]' the Company's previous statements with its most recent letter to the agency," it was "plausible . . . to construe the March 23 letter as showing National Beverage's 'fail[ure] to cooperate with the SEC and refus[al] to give it the information requested regarding sales,'"[330] which the court suggested was enough to allege a corrective disclosure, alone, under any applicable pleading standard.[331]

Concerning the alleged misstatements about sexual misconduct in violation of the company's publicized description of its code of ethics, the Eleventh Circuit held that the complaint failed to plead that the July 3, 2018 *Wall Street Journal* article about harassment of the pilots on the private jet provided "news to the market," as the article referenced pleadings from two "cases . . . filed in the same court as [the Rule 10b-5 case, with that court having] yielded dispositive, publicly accessible orders before the July 3 article was published."[332] Accordingly, although the court acknowledged that it is possible for a report on a lawsuit to bring new information to the market and thereby constitute a corrective disclosure (e.g., where the lawsuit was "'filed in an unlikely venue'" and had "'received no publicity whatever'"), here "the July 3 article did not 'present facts to the market that [were] new, that is, publicly revealed for the first time,'" and

328. *Id.*

329. *Id.* at 923.

330. *Id.*

331. *Id.* (the "allegations are sufficiently specific so as to 'enable the [district] court to evaluate whether the necessary causal link exists.' *See* Katyle [v. Penn Nat'l Gaming, Inc.], 637 F.3d [462,] 471 [(4th Cir. 2011)] (quotation marks omitted)"); *see id.* at 920 (noting that the circuit had "never taken a position on whether the PSLRA's heightened pleading standards apply to allegations of loss causation" and declining to do so because the complaint "has alleged loss causation with regard to his VPO/VPC claim even under the heightened pleading standards of Rule 9(b) and the PSLRA").

The court of appeals similarly held that the district court took too narrow a view of the June 26 *Wall Street Journal* article, at least for a motion to dismiss, by interpreting it as supplying no new information to the market but simply summarizing already public company/SEC correspondence. *Id.* at 923. Since the article sourced its report to unidentified "'correspondence with the agency,'" *id.* at 922, it "was not proper for the district court to assume, at the motion to dismiss stage, that the June 26 article's use of the word 'filings' meant the March 23 letter or any other public correspondence between the Company and the SEC," *id.* at 923.

The court of appeals also found that the complaint sufficiently alleged (i) that the press release statements about VPO/VPC were false, (ii) scienter, and (iii) materiality. *Id.* at 924–25.

332. *Id.* at 926.

therefore "the district court did not err in dismissing the sexual harassment claim for failure to plead loss causation."[333]

FOIA Requests, *Seeking Alpha* posts, and loss causation. The Ninth Circuit addressed the relationship of FOIA requests to loss causation in *Grigsby v. BofI Holding, Inc.* ("BofI").[334] The plaintiffs alleged that BofI and executives violated Rule 10b-5 by (i) responding to a March 31, 2017 *New York Post* article reporting that the DOJ (with SEC involvement) was investigating the bank for money laundering by issuing a press release saying that BofI had "received no indication of, and ha[d] no knowledge regarding, such purported money laundering investigation";[335] and (ii) responding to a whistleblower complaint "alleg[ing] that BofI 'failed to disclose loans to criminals and politically exposed persons who put the Bank at risk for violating the Bank Secrecy Act's Anti-Money Laundering Rules'" by issuing a press release in April 2016 saying that this allegation was "'disconnected from the reality of BofI's highly compliant and top-performing business.'"[336] After the district court dismissed the complaint for failure to plead loss causation, the Ninth Circuit reversed in part and affirmed in part.[337]

The plaintiffs pled that a *New York Post* article on October 25, 2017 constituted a "corrective disclosure" showing that the company's press release responding to the March 2017 story was false.[338] That October article reported that BofI had been under investigation by the SEC for sixteen months, and the bank's stock price declined by 4.57 percent the next day.[339] The *New York Post* article was itself "based on a report by a subscription research service called *Probes Reporter* that obtained information about the SEC investigation through a FOIA request."[340] Starting from the well-recognized notion that a corrective disclosure generally cannot consist of "information 'derived "entirely from public filings and other publicly available sources" of which the stock market was presumed to be aware,'" the defendants "contend[ed] that 'because market actors could access the [FOIA] information . . . BofI's stock price already reflected it' when the *Post* published its [October] article," and, accordingly, the article could not have brought about a correction in the bank's stock price.[341] Taking into account that "information must be requested before it can be received" via a FOIA request and that requested information must then, after being received, be "produced before it is publicly available," the Ninth Circuit held that "[a]t

333. *Id.* (quoting Staehr v. Hartford Fin. Servs. Grp., Inc., 547 F.3d 406, 435 (2d Cir. 2008)). Consistent with its declination to choose which pleading standard applies to loss causation, *see supra* note 331, the court held that the shareholder "has not alleged loss causation with regard to his sexual harassment claim even under Rule 8(a)(2)'s notice pleading requirement," the lowest of the standards that might apply. *Id.* at 920.

334. 979 F.3d 1198 (9th Cir. 2020).

335. *Id.* at 1203 (alteration by the court).

336. *Id.* at 1202, 1208.

337. *Id.* at 1202–03, 1209.

338. *Id.* at 1203.

339. *Id.*

340. *Id.*

341. *Id.* at 1205 (quoting Loos v. Immersion Corp., 762 F.3d 880, 889 (9th Cir. 2014) (quoting Meyer v. Greene, 710 F.3d 1189, 1198 (11th Cir. 2013))).

a minimum, there must be some indication that the relevant information was requested and produced before the information contained in a FOIA response can be considered publicly available for purposes of loss causation."[342] Accordingly, "the district court erred by concluding as a matter of law that an article containing information obtained through the FOIA could not qualify as a corrective disclosure."[343]

The court of appeals then further held that the plaintiffs were under no obligation—in order to rely on the *New York Post* report—to plead facts "show[ing] that no one else had obtained the same information through the FOIA before the October 25, 2017 article."[344] It sufficed that "[t]he operative complaint alleged that the *Post* article disclosed BofI had been the subject of a formal SEC investigation, that the article revealed the falsity of BofI's prior statement, and that the revelation caused BofI's stock price to drop."[345] As the Ninth Circuit pronounced, "plaintiffs relying on corrective disclosures that are in turn based on information obtained through the FOIA do not face a special pleading burden for purposes of alleging § 10(b) loss causation."[346]

Finally, as to the October 2017 article, the Ninth Circuit rejected the defense argument that the *Post* story was not corrective because it did not contradict BofI's denial of the March story.[347] Addressing the circumstance that the October article did not refer to money laundering whereas the bank's response to the March article said the bank had no knowledge of a money laundering investigation, the court of appeals wrote: "[a]lthough the October 25, 2017 *Post* article did not precisely mirror BofI's denial, its report that the SEC had investigated BofI for money laundering sufficiently related back to BofI's statement that it had no knowledge of a money laundering investigation involving the SEC."[348] The court based this conclusion in part on the *Post*'s own characterization in the October article that it "'confirmed two earlier reports by *The Post* that the bank was under investigation.'"[349]

But the Ninth Circuit did affirm the trial court's ruling that an internet article posted on *Seeking Alpha* by an anonymous author did not constitute a corrective disclosure showing the falsity of BofI's characterization of a whistleblower complaint as "disconnected from the reality of BofI's highly compliant and top-performing

342. *Id.* at 1205–06.

343. *Id.* at 1206.

344. *Id.*

345. *Id.*

346. *Id.* The court of appeals then examined the plaintiffs' second amended complaint to consider whether it included allegations that earlier FOIA requests had already unearthed the SEC's investigation of BofI. *Id.* at 1207. Those allegations said that SEC FOIA logs "showed that five other BofI-related FOIA requests were submitted to the SEC, 'granted' at least in part, and listed as 'closed' prior to the October 25, 2017 *Post* article." *Id.* But this sparse information did "not allow the conclusion that any of the other BofI-related FOIA requests resulted in the disclosure of information about an SEC investigation of BofI." *Id.*

347. *Id.* at 1207–08.

348. *Id.* at 1208. As set out in the text accompanying *infra* note 354, the October story does not use the term "money laundering" at all. The court's comment about "relat[ing] back" to the March story may derive from the March story's statement that the SEC was involved in the DOJ investigation it reported. *See infra* note 353 and accompanying text.

349. *Id.*

business."[350] In this instance, the post itself said it was based on already public information and, since "[t]he article's analysis did not require any expertise or specialized skills beyond what a typical market participant would possess" and therefore added nothing new to which an efficient market would react by correcting the bank's stock price, the post could not demonstrate loss causation.[351]

Significance and analysis. It is difficult to understand the portion of *Grigsby* discussing whether the *New York Post*'s October 2017 story "corrected" BofI's press release saying it "had 'received no indication of, and ha[d] no knowledge regarding, [the] purported money laundering investigation'" reported in the *New York Post*'s March article.[352] The March article specifically concerned a money-laundering investigation led by the DOJ, with the story adding that the SEC was "also in the probe."[353] The October article reports (i) an SEC investigation; (ii) states that BofI "was the subject of scrutiny until June—when it ceased without the SEC taking any action"; (iii) does not mention money laundering at all; (iv) says only that the investigation it reports concerned "alleged conflicts of interests, auditing practices, and loans made to two entities"; and (v) while the October report does indeed ballyhoo that this different investigation "confirmed two earlier reports by *The Post* that the bank was under investigation" it also states—after linking to the March story—that the March report was based on "public documents obtained in an unrelated case."[354] On reading the two stories, it is hard to see how the October article shows the falsity of the bank's statement following the March article that the bank had no knowledge that the DOJ was investigating it for, specifically, money laundering. Perhaps that denial, in context, arguably misled without reference to an entirely different government investigation. But the Ninth Circuit seemed to have a more convoluted idea.[355]

The portion of the opinion affirming that the *Seeking Alpha* post was not corrective proves difficult reading as well. If, indeed, the market dropped the price of BofI stock after a post, and if there was no other information to which the market might have been reacting in such a way at the time of that decline,[356] the decline by itself is very arguably evidence that the post provided new information—if only by connecting bits and pieces of information, each of

350. *Id.*

351. *Id.* at 1207–08; *id.* at 1203 (quoted language).

352. *See* text accompanying *supra* notes 347–49.

353. Kevin Dugan, *Feds Probe Bank of Internet for Possible Money Laundering*, N.Y. Post (Mar. 31, 2017, 1:27 AM), https://nypost.com/2017/03/31/feds-probe-bank-of-internet-for-possible-money-laundering/.

354. Kevin Dugan, *Bank of Internet Was Under 16-Month SEC Investigation*, N.Y. Post (Oct. 25, 2017, 10:55 PM), https://nypost.com/2017/10/25/bank-of-internet-was-under-16-month-sec-investigation/.

355. *See supra* note 348 and accompanying text.

356. The plaintiffs' reply brief on appeal states: "The author of the *Seeking Alpha* article put the pieces of the separate information together and revealed for the first time with sufficient 'intensity and credibility' that BofI was making loans to criminals. Proof of this, which again Defendants have no response to, is the fact that BofI's stock price dropped significantly when the truth was revealed. Compl. ¶ 122, ER 145. No other factors caused the drop." Plaintiffs-Appellants' Reply Brief, Grigsby v. BofI Holding, Inc., 979 F.3d 1198 (9th Cir. 2020) (No. 19-55042), 2019 WL 2902644, at *17.

which was publicly available before. The opinion reads more like judicial reasoning of how the market *should* have reacted (i.e., by no price drop at all) rather than to how it *did* react (i.e., with a price decline). Perhaps that is proper, but if this was the court's theory, the panel would have done well to acknowledge that it was playing a gatekeeper role rather than simply following market reaction.

Whistleblower case and *Seeking Alpha* posts as corrective disclosures. The Ninth Circuit authored a second opinion addressing loss causation, in which the BofI was again the entity defendant—*In re BofI Holding, Inc. Securities Litigation*—but in which the plaintiffs alleged an earlier fraud than in *Grigsby*.[357] The plaintiffs asserted that the bank had (i) misrepresented that its loan underwriting standards were "'conservative,'" it had "'not sacrificed credit quality to increase origination,'" and it "'continue[d] to originate only full documentation, high credit quality, low loan-to-value, jumbo single-family mortgages'"; and (ii) falsely or misleadingly stated that it had "'made significant investments in our overall compliance infrastructure over the past several quarters, including BSA [Bank Secrecy Act] and AML [anti-money laundering] compliance'" and "'spent a significant amount of money on BSA/AML compliance upgrades and new systems and new personnel.'"[358] Reversing dismissal,[359] the Ninth Circuit held that the plaintiffs adequately alleged loss causation by one of the two types of corrective disclosures identified in the complaint.[360]

In the course of its analysis, the Ninth Circuit observed that (i) a plaintiff invoking the FOTM presumption must, in order to establish loss causation, "show that after purchasing her shares and before selling, the following occurred: (1) 'the truth became known,' and (2) the revelation caused the fraud-induced inflation in the stock's price to be reduced or eliminated"; (ii) a corrective disclosure need not come from defendants but can originate "from any source, including knowledgeable third parties such as whistleblowers, analysts, or investigative reporters"; (iii) such a disclosure need not show the complete fraud the plaintiff alleges but suffices if it "reveals new facts that, taken as true, render some aspect of the defendant's prior statements false or misleading"; (iv) a plaintiff satisfies the loss causation element by showing that the revelation in the disclosure was a substantial cause of an ensuing stock price drop and does not have to show that it was the only cause of the decline; and (v) although loss causation allegations must meet Rule 9(b)'s particularity standard, a complaint passes muster if it "give[s] the defendant 'notice of plaintiffs' loss causation theory' and provide[s] the court 'some assurance that the theory has a basis in fact.'"[361]

357. 977 F.3d 781 (9th Cir. 2020). The *In re BofI Securities Litigation* cases alleged fraud during a class period running from September 4, 2013 to February 3, 2016. *Id.* at 786. The *Grigsby* plaintiffs alleged a later fraud, with a class period beginning on March 14, 2016. Defendant-Appellee's Answering Brief, Grigsby v. BofI Holding, Inc., 979 F.3d 1198 (9th Cir. 2020) (No. 19-55042), 2019 WL 2145029, at *7.

358. *In re BofI Sec. Litig.*, 977 F.3d at 786–87.

359. *Id.* at 798.

360. *Id.* at 786.

361. *Id.* at 789–90, 794 (quoting Berson v. Applied Signal Tech., Inc., 527 F.3d 982, 989–90 (9th Cir. 2008)).

Here, the complaint alleged that the filing of a whistleblower's lawsuit and the report on its details by the *New York Times* constituted one corrective disclosure.[362] While the district court had ruled the suit could not be a corrective disclosure because it contained only allegations,[363] the court of appeals held that the plaintiffs in the securities lawsuit "did not have to establish that the allegations in [the whistleblower's] lawsuit [were] in fact true."[364] Instead, "the relevant question for loss causation purposes is whether the market reasonably *perceived* [those] allegations as true and acted upon them."[365] In this case, the whistleblower's "descriptions of wrongdoing [were] highly detailed and specific, and they [were] based on firsthand knowledge that he could reasonably be expected to possess by virtue of his position as a mid-level auditor at the company."[366] In particular, he alleged that BofI "had doctored reports submitted to the bank's primary regulator, the Office of the Comptroller of the Currency (OCC), . . . BofI had made high-risk and illegal loans to foreign nationals," and "his attempts to raise these compliance issues within the company led to retaliation and eventually to his termination."[367] Since "BofI's stock price plunged by more than 30% on extremely high trading volume immediately after the market learned of [the whistleblower's] allegations," the court inferred "that the market regarded his allegations as credible."[368] Since "the drop is not readily attributable to non-fraud-related factors that might have moved BofI's stock price that day," the complaint provided both notice of the loss causation theory and some assurance that it was based in fact—enough at the pleading stage.[369] The panel rejected any categorical rule that the filing of a lawsuit cannot constitute a corrective event, but noted that some allegations are more credible than others and, "[i]f the market treats allegations in a lawsuit as sufficiently credible to be acted upon as truth, and the inflation in the stock price attributable to the defendant's misstatements is dissipated as a result, then the allegations can serve as a corrective disclosure."[370]

The *BofI Securities Litigation* plaintiffs alleged, as a second corrective event, a series of blog posts on the *Seeking Alpha* site.[371] As to these, the Ninth Circuit

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362. *Id.* at 788. The whistleblower complaint in this case appears to be the same one as in *Grigsby*. See the lower court *Grigsby* decision at *Mandalevy v. BofI Holding, Inc.*, Case No.: 17cv667-GPC-KSC, 2018 WL 6436723, at *1 (S.D. Cal. Dec. 7, 2018) (referring to a suit by "Matt Erhart," "a former internal auditor at BofI"), and *BofI Holding*, 977 F.3d at 788 (referring to a "lawsuit filed against BofI by Charles Erhart, a former mid-level auditor at the company").

363. *BofI Holding*, 977 F.3d at 788.

364. *Id.* at 791.

365. *Id.* at 792.

366. *Id.* For example, the whistleblower alleged that he provided a senior vice president with a list of customers—constituting about 30 percent of the bank's borrower base—that a private vendor had identified to have such "red flags" as "suspiciously high cash balances, social security numbers that did not match any public records, and, in one instance, the social security number of a dead person," only to have the senior vice president "demand[]that the audit committee alter the list and give the altered version to the OCC [Office of Comptroller of the Currency]." *Id.* at 791.

367. *Id.* at 788.

368. *Id.* at 792.

369. *Id.* at 792, 794.

370. *Id.* at 792.

371. *Id.* at 788.

agreed with the district court determination that they could not show loss causation.[372] While the court of appeals (and to this extent differing from the lower court's rationale) acknowledged that "[a] disclosure based on publicly available information can, in certain circumstances, constitute a corrective disclosure," such an argument must be "plausible," taking into account such factors as the complexity of the public information and the need for expert analysis in order that the market understand the information's significance.[373] While some of the *Seeking Alpha* posts "required extensive and tedious research involving the analysis of far-flung bits and pieces of data" and while this circumstance made "it plausible that the posts provided new information to the market," it was "not plausible that the market *reasonably* perceived these posts as revealing the falsity of BofI's prior misstatements, thereby causing the drops in BofI's stock price on the days the posts appeared," given that the posts "were authored by anonymous short-sellers who had a financial incentive to convince others to sell, and the posts included disclaimers from the authors stating that they made 'no representation as to the accuracy or completeness of the information set forth in this article.'"[374]

Significance and analysis. The court's analysis of the whistleblower complaint seems largely sound. The question is whether the complaint—taking into account such factors as the plaintiff (e.g., the SEC or an insider whistleblower) and the details it provides (and whether they are new)—raises, as the panel member who concurred in this part of the opinion put it, the "'risk of future corrective'" events, which could devalue the company.[375] If the market—presumably taking

372. *Id.* at 794.

373. *Id.* at 795.

374. *Id.* at 797 (emphasis added). Although the *Seeking Alpha* posts also related to the same alleged misstatements as the whistleblower complaint, *id.* at 796–97, the posts were on different dates than the whistleblower's lawsuit filing and news report of that filing, *id.* at 788, 796–97. If the plaintiffs had succeeded in pleading loss causation by stock price declines after these posts, they would have increased their potentially recoverable damages.

In another holding worth noting, the Ninth Circuit determined that a "new category of misstatements" that the BofI plaintiffs sought to include in a third amended complaint were insufficient to state a claim. *Id.* at 798. Most of these were characterizations, such as the CEO saying "that regulatory review 'is beyond a nonissue' and that '[w]e have great regulatory relations.'" *Id.* Since these were only the CEO's "opinions and predictions," they were "not actionable." *Id.* Moreover, while the SEC was investigating the bank at the time of these statements, "it is unclear whether anyone at BofI was aware of that fact" when the CEO spoke and "his statements were specifically limited to the OCC in any event." *Id.* Because the plaintiffs did not allege that the CEO "had an independent duty to disclose the SEC investigation," there was no asserted "obligation [on his part] to mention it." *Id.* This seems out of sync with the portion of the *Grigsby* opinion that at least suggested that the bank, in denying any knowledge of one government investigation, misled by failing to mention another government investigation. *See supra* notes 347–49, 352–55 and accompanying text.

In re BofI delivered a split decision. One of the panel dissented in part, concluding that "if a securities fraud lawsuit turns on insider allegations of wrongdoing in a whistleblower lawsuit, I would prefer a bright-line rule that requires an external disclosure or evidence that confirms those allegations," such as "a surprise restatement of earnings, an unexplained announcement about an increase in reserves, or some other information that confirms those allegations and thus acts as a corrective disclosure." *Id.* at 801 (Lee, J., concurring in part and dissenting in part).

375. *Id.* at 800 (Lee, J., concurring in part and dissenting in part) (quoting Meyer v. Greene, 710 F.3d 1189, 1201 (11th Cir. 2013)).

these same factors into account—finds the whistleblower's complaint to increase the probability of devaluation and accordingly drops the stock price, then by the court's analysis the whistleblower complaint can constitute a corrective disclosure.[376]

The problem is that the court departs from this construct when it addresses the *Seeking Alpha* blog posts. The plaintiffs alleged that the price of BofI's stock declined on each day that the blog posts appeared—all eight of them.[377] If the market is the definitive judge of whether a disclosure is corrective or not, then it should be the judge of the blog posts as well as the whistleblower complaint. But the panel does not want that result, evidently, and to reach its result inserts its own investor analysis, opining without any empirical basis that "[a] reasonable investor reading these posts would likely have taken their contents with a healthy grain of salt."[378] As in *Grigsby*, a better (or more honest) analysis might be that the court wants to serve as a gatekeeper. Just as a court might conclude that a "reasonable investor" would not attribute importance to a fact for purposes of determining its materiality—even if the market moved after the fact became known—a court might conclude that a report would not influence a "reasonable investor" for the purpose of determining whether the fact's revelation provided a corrective disclosure, even if the report in fact moved the market. This is the same issue that permeates the *Grigsby* decision summarized earlier, where the same circuit seemingly overlaid a gatekeeper role on a market analysis.

Insider trading. The law recognizes two principal theories of Rule 10b-5 insider trading: the classical theory that forbids a corporation's insiders from trading in their company's equity securities on information they acquired during their work for the company that was intended to be used solely for corporate purposes, unless the insider discloses the information to opposite side traders (with the fraud here on those traders); and the misappropriation theory that forbids a recipient of information—provided by a source to whom the recipient owes a duty of trust and confidence—from trading on it without telling the source of the information (with the fraud here on that source).[379] In *United States v. Kosinski*, the Second Circuit affirmed, on the misappropriation theory, the insider trading conviction of a doctor involved in a drug trial, but in doing so drew on analysis in a case resting on the classical theory.[380]

Dr. Kosinski participated in phase 3 clinical trials of a drug manufactured by Regado Biosciences, Inc. ("Regado").[381] On October 8, 2013—after signing a confidential disclosure agreement with Regado—Kosinski bought 2,000 shares

376. *See* the quotation in text at *supra* note 370.
377. *Id.* at 788.
378. *Id.* at 797.
379. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).
380. 976 F.3d 135, 139, 144, 157 (2d Cir. 2020), *petition for cert. filed*, No. 20-1161 (Feb. 19, 2021).
381. *Id.* at 139–40.

of Regado stock, followed by 2,000 more the next day.[382] Later in October, he falsely represented to a hospital, in seeking permission to administer the drug to patients there, that he did not own any Regado stock.[383]

On January 22, 2014, Connecticut Clinical Research LLC, of which Kosinski was president, signed a Clinical Study and Research Agreement ("CSRA") with a foundation acting on behalf of Regado, by which Kosinski became a "principal investigator" at one of the many sites for the clinical trial.[384] In his capacity as a principal investigator, Kosinski "was responsible for recruiting the subjects, determining their suitability, monitoring their tolerance and reaction and reporting the results" at the site.[385] The CSRA "required [him] (1) to maintain in 'strict confidence' all the information with which he was provided to enable him to perform as principal investigator; and (2) to complete a financial disclosure form called a Form FDA 1572, which in turn required that he 'promptly' disclose to Regado if the value of his Regado stock exceeded $50,000."[386]

In February 2014, Kosinski bought an additional 2,000 Regado shares and, even though this purchase pushed the value of his Regado stock over $50,000, he did not report this fact to Regado.[387] In April and May, he bought a further 31,000 shares of Regado, still without reporting his holdings—now worth about $250,000—to the company.[388]

After receiving an email from the study's management team on June 29, 2014, advising all principal investigators of a hold on enrolling new patients because of "'several allergic reactions over the past few weeks, and the [data safety monitoring board] and trial leadership need[ing] time to review the recent events thoroughly," Kosinski sold all his Regado shares the next day.[389] When the hold, and the reason for it, became public on July 2, the price of Regado stock declined 58 percent.[390] After receiving an email from the study management team on July 29—this one advising that one patient in the study had died and that the entire study was on hold—Kosinski two days later bought put options on fifty shares of Regado stock, which he later exercised and satisfied with Regado stock he bought cheap, after Regado announced that the entire clinical trial had been abandoned due to frequent and severe allergic reactions to the drug and its stock price dropped further.[391]

The misappropriation theory depends on a sufficient relationship between the source of the information and the recipient that the recipient's use of the information for personal trades constitutes a fraud on the source. After conviction under this theory, Kosinski argued on appeal that the evidence was insufficient

382. *Id.* at 141.
383. *Id.*
384. *Id.* at 140.
385. *Id.* at 139.
386. *Id.* at 140.
387. *Id.* at 141.
388. *Id.*
389. *Id.*
390. *Id.*
391. *Id.* at 141–42.

to show that he had such a relationship with Regado.[392] In response, the Second Circuit leaned on *United States v. Falcone*, which characterized the required connection as "'a fiduciary relationship, or its functional equivalent, [that] exists only where there is explicit acceptance of a duty of confidentiality or where such acceptance may be implied from a similar relationship of trust and confidence between the parties. Qualifying relationships are marked by the fact that the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such information.'"[393]

The panel concluded that the corporate "temporary insiders" identified in *Dirks v. SEC* have such a relationship with a corporation they serve.[394] Although the Second Circuit acknowledged that *Dirks* was litigated on the classical insider trading theory, the *Dirks* reasoning "likewise encompasses those who have entered into a 'special confidential relationship,' that has enabled them to misappropriate information that was 'intended to be available only for a corporate purpose and not for the personal benefit of anyone.'"[395] The court of appeals then determined that Kosinski was a "temporary insider," on the reasoning that he "was entrusted with Regado's information solely because of his duty to ensure the integrity and accuracy of the phase three clinical trial, as well as the health of his patients," "would not have been provided this information absent his 'explicit acceptance of a duty of confidentiality,'" and had "further agreed to disclose if his holding of Regado stock exceeded $50,000, which presumably would have triggered Regado's closer oversight of Kosinski (or even his termination) given its significance to the FDA."[396]

The court went on to hold that Kosinski's "relationship with Regado was fiduciary in nature because it was a relationship based upon trust and confidence," his "experience and skill were important to . . . Regado receiving FDA approval for [the drug] and the financial reward that would accompany it," and his use of study information for his own financial gain "depriv[ed] the company of the independent assessment required for FDA approval" because it gave him "an incentive to lie about or conceal patients' results in order to influence the study's outcome, and ultimately his wallet," and thereby "undermine[d the] study's integrity."[397] The CSRA's requirement that Kosinski hold information in "'strict confidence'" gave Regado the "'trust and confidence'" to provide him with "critical

392. *Id.* at 142.

393. *Id.* at 144 (quoting United States v. Falcone, 257 F.3d 226, 234–35 (2d Cir. 2001)).

394. *Dirks* included a footnote, saying that "[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." 463 U.S. 646, 655 n.14 (1983). *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir. 1991) (en banc), dubbed the *Dirks* footnote 14 actors "temporary insiders." *See Kosinski*, 976 F.3d at 144.

395. *Kosinski*, 976 F.3d at 144–45 (citation omitted) (quoting *Dirks*, 463 U.S. at 654).

396. *Id.* at 145 (quoting *Falcone*, 257 F.3d at 234).

397. *Id.* at 146.

inside information" and was "itself sufficient to establish the necessary fiduciary duty of trust and confidence."[398]

Dealing with the Second Circuit's *United States v. Chestman* decision, which held "that '[a]t the heart of the fiduciary relationship lies reliance, and de facto control and dominance,'"[399] the court of appeals found all three attributes present here because, "while control of [the drug being tested] was Regado's at the outset, it ceded that control, at least for purposes of conducting the Study, to principal investigators, such as Kosinski, relying on their superior medical skill and expertise, and affording them dominance in assessing how the drug actually performed for patients."[400] But the panel went out of its way to observe that this formulation from *Chestman* was not the "only appropriate standard from which the jury could find the requisite fiduciary relationship."[401] Thus, "*Chestman* itself set out two other tests, . . . one of which is the traditional test that one acts as a fiduciary when 'the business which he transacts, or the money or property which he handles, is not his own or for his own benefit, but for the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part.'"[402] Finding that "[t]his traditional test aptly describes the relationship between Kosinski and Regado," the court then proceeded to the "most significant" test, from the *Falcone* decision, "which holds that a fiduciary relationship can arise so long as 'the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such information.'"[403]

398. *Id.* The court rejected Kosinski's argument that he did not have a fiduciary relationship with Regado because the CSRA itself characterized him as an independent contractor, saying that the temporary insiders identified in the *Dirks* footnote could be so characterized and, in any event, "we do not afford the contractual term 'independent contractor' controlling effect where such a term, even in a private contract, implicates significant public policies." *Id.* at 148. The panel also rejected his argument that he dealt with Regado at "arms-length," observing that that term "is often used but rarely defined" and that an arm's-length relationship might suffice to underlie a misappropriation case if it also included "'trust and confidence.'" *Id.* at 148–49 (quoting Muller-Paisner v. TIAA, 289 F. App'x 461, 466 (2d Cir. 2008) (interpreting *In re* Mid-Island Hosp., Inc., 276 F.3d 123, 130 (2d Cir. 2002) (internal quotation omitted))).

399. *Id.* at 149 (quoting *Chestman*, 947 F.2d at 568).

400. *Id.*

401. *Id.*

402. *Id.* at 151 (quoting *Chestman*, 947 F.2d at 568–69 (quoting BLACK'S LAW DICTIONARY (5th ed. 1979))).

403. *Id.* (quoting *Falcone*, 257 F.3d at 234–35).

Since the government prosecuted Kosinski under the criminal provision in the Exchange Act, it had to prove that he had "willfully violate[d]" a section of that Act or a regulation adopted under it. 15 U.S.C. § 78ff(a) (2018). Disagreeing with Kosinski's contention that the court should have instructed that the government needed to prove that "he knew that his conduct was unlawful under the securities laws," *Kosinski*, 976 F.3d at 153, the panel held that "[a]s a general matter, 'a person who acts willfully need not be aware of the specific law that his conduct may be violating. Rather, knowledge that the conduct is unlawful is all that is required,'" *id.* at 154 (quoting United States v. Henry, 888 F.3d 589, 599 (2d Cir. 2018) (some internal quotation marks omitted)). As to sufficiency of the evidence to support willfulness, the court of appeals found (i) that Kosinski was a sophisticated trader; (ii) "knew that he was trading on nonpublic inside information"; (iii) had admitted to the FBI "that he did not feel good about the trades at the time he made them (that they were the product

Significance and analysis. The court declined to consider the SEC's rule setting out the Commission's non-exclusive definition of relationships that qualify to support a misappropriation case,[404] and *Kosinski* provides a smorgasbord of other formulations for a sufficient relationship. At the same time, the decision leaves a suspicion that the court might not approve of the SEC regulatory definition in Rule 10b5-2, because that one does not require a fiduciary relationship,[405] which the *Kosinski* opinion emphasizes.[406]

Proxy statements. Exchange Act section 14(a) prohibits solicitation of proxies to vote shares registered under section 12 of that act in contravention of SEC rules, and the related SEC Rule 14a-9 forbids such proxy solicitations from either including false material facts or "omit[ting] to state any material fact necessary in order to make the statements therein not false or misleading."[407] Since SEC rules permit combining a proxy statement with a prospectus when securities constitute all or part of the consideration for a merger,[408] the combined document creates possible liability for the recipients of the shares under Securities Act sections 11 and 12.[409]

After Hudson City Bank ("Hudson") and M&T Bank ("M&T") agreed to merge (with M&T as the surviving bank, paying for the merger with its shares or cash, at the election of each Hudson shareholder), the two banks filed a joint proxy statement/prospectus (on registration statement Form S-4), which included a "risk factors" section pursuant to Regulation S-K Item 503—now Item 105.[410] That Item requires disclosure of "the most significant factors that make an

of 'greed and stupidity')"; and (iv) that he "was only able to engage in the charged conduct because of lies and deceit," for example, by lying to the hospital in order to obtain its permission to use the trial drug on patients there. *Id.* at 155.

404. *Kosinski*, 976 F.3d at 147 n.5 (citing 17 C.F.R. § 240.10b5-2(b)(1)).

405. For example, Rule 10b5-2(b)(1) provides that a simple agreement to keep information confidential suffices to create a relationship sufficient to support a misappropriation case. Such an agreement might be made between two parties on opposite sides of a commercial transaction in which neither one is acting for the other's benefit.

406. In another insider trading case originating in the life sciences industry, the First Circuit affirmed convictions, sentences, and a restitution order in *United States v. Chan*, 981 F.3d 39, 45, 66 (1st Cir. 2020). The defendant biostatisticians traded in each other's company's stock, with one of the defendants also trading in the stock of his own company. *Id.* at 45–48. In each instance the defendant purchased stock within days of positive reports from clinical trials that the issuer had underway. *Id.* at 58–60. In a notable holding, the court adopted the Second and Tenth Circuits' calculation of insider trading gains for purposes of U.S. Sentencing Guideline 2B1.4—the difference between what the defendant paid for the security and the price of that security a reasonable time after the information on which the defendant traded becomes public—instead of the difference between the amount the defendant paid and the price for which he sold the security, used by the Eighth Circuit, which the *Chan* panel criticized as leaving sentences dependent on "market fluctuations unrelated to the offense of insider trading." *Id.* at 62–64 (quotation at 64).

407. 15 U.S.C. § 78n(a) (2018); 17 C.F.R. § 240.14a-9 (2020).

408. SEC Form S-4, Gen. Instruc. E.

409. J. William Hicks, Civil Liabilities: Enforcement & Litig. Under the 1933 Act §§ 4:21, 6.37 (2020).

410. Jaroslawicz v. M&T Bank Corp., 962 F.3d 701, 705–06 (3d Cir. 2020), *cert. denied*, No. 20-678, 141 S. Ct. 1284 (2021) (mem.); M&T Bank Corp., Preliminary Proxy Statement/Prospectus (Form S-4/A) (Feb. 21, 2013), https://www.sec.gov/Archives/edgar/data/0000036270/00011931251 3069016/d403529ds4a.htm.

investment in the registrant or offering speculative or risky."[411] The S-4 included in disclosed risks that (i) M&T was "'subject to extensive government regulation and supervision'"; (ii) "'M&T [was], or [might] become, the subject of governmental and self-regulatory agency information-gathering requests, reviews, investigations and proceedings and other forms of regulatory inquiry'"; and (iii) M&T ran the "'risk of loss from violations of, or noncompliance with, laws, rules, regulations, prescribed practices or ethical standards.'"[412] In addition, the S-4 disclosed that the merger's completion required the approval of the Federal Reserve Board, which would among other things evaluate "'the effectiveness of the companies in combatting money laundering.'"[413] While M&T stated its belief that the necessary approvals would issue in a timely way, it made no guarantee.[414] M&T incorporated by reference its most recent 10-K, in which it said that the Patriot Act required all banks to "'implement and maintain appropriate policies, procedures and controls which are reasonably designed to prevent, detect and report instances of money laundering,'" as well as its belief that M&T's policies and procedures complied with that legal requirement.[415]

Before the shareholder votes, M&T disclosed in a supplemental proxy statement "that the Federal Reserve Board [had] identified 'certain regulatory concerns' about 'procedures, systems and processes relating to M&T's Bank Secrecy Act and anti-money-laundering compliance program,'" and that, as a result, "'the timeframe for closing the transaction will be extended substantially beyond the date previously expected.'"[416] After the shareholders of both merging banks "overwhelmingly approved" the deal but before the Federal Reserve Board cleared the merger, the Consumer Financial Protection Bureau ("CFPB") publicly revealed that it was pursuing M&T for signing up customers for free checking accounts, then—without notice—moving the customers to accounts that charged fees.[417] As it turned out, regulatory approval for the merger took two and a half years.[418]

Before the closing, Hudson shareholders sued in *Jaroslawicz v. M&T Bank Corp.*, alleging violation of Exchange Act section 14(a) and SEC Rule 14a-9.[419] The shareholders contended that M&T failed to disclose material risk factors because the S-4 "did not discuss M&T's non-compliant BSA/AML practices and deficient consumer checking program."[420] The shareholders also contended "that M&T's failure to discuss these allegedly non-compliant practices rendered

411. *Jaroslawicz*, 962 F.3d at 705–06 (quoting 17 C.F.R. § 229.105).
412. *Id.* at 706 (quoting S-4).
413. *Id.*
414. *Id.*
415. *Id.* at 706–07.
416. *Id.* at 707.
417. *Id.*
418. *Id.*
419. *Id.* at 708; *see* 15 U.S.C. § 78n(a) (2018); 17 C.F.R. § 240.14a-9 (2020). The stockholders also alleged a breach of state fiduciary duty, *Jaroslawicz*, 962 F.3d at 708, but this summary will not address that claim.
420. *Jaroslawicz*, 962 F.3d at 708.

M&T's opinion statements about its adherence to regulatory requirements and the prospects for prompt approval of the merger, misleading."[421]

Reversing the district court's dismissal insofar as it reached the asserted failure to warn of risks,[422] the Third Circuit held that the S-4 contained only "generic" warnings of risks from regulatory action, including the possibility that the Federal Reserve would delay merger approval because of inadequate M&T anti-money-laundering compliance,[423] and "omitted company-specific detail about its compliance program."[424] The court of appeals concluded that "[a]s a result, the Shareholders have plausibly alleged that had M&T disclosed the state of its BSA/AML program in the context of regulatory scrutiny that program would face, 'there is a substantial likelihood that a reasonable shareholder would [have] consider[ed] it important in deciding how to vote.'"[425]

The Third Circuit reached the same conclusions with respect to the checking account wrongdoing, reasoning that (i) "the Shareholders claim that M&T was, in fact, aware" that it was switching free-checking customers to fee accounts without their notice; (ii) the S-4 "did not mention the non-compliant practice or the company's steps to remediate the action"; and (iii) "the consumer checking practices cast doubt on M&T's controls and compliance systems, and posed an independent regulatory risk to the merger material enough that a reasonable shareholder would consider it important in deciding how to vote."[426]

As to the claims that M&T misled by its *opinions* about "when it believed the merger might close" and "the state of its [anti-money-laundering] program" (incorporated into the S-4 by incorporation of the 10-K), the Third Circuit affirmed the dismissal below.[427] Analyzing these opinions through the lens the Supreme Court provided in *Omnicare*[428]—while stating both that (i) *Omnicare* "provides the relevant framework" but that (ii) the court was not holding that *Omnicare* applies to Exchange Act claims but only finding no claim "[e]ven assuming *Omnicare's* holding applies here"[429]—the court of appeals noted (i) "no allegation that M&T offered an insincere opinion" and (ii) any claim that the S-4 misled because such opinions were based on insufficient due diligence failed because the S-4 itself disclosed the extent of that diligence.[430]

421. *Id.*

422. *Id.* at 716–17, 718.

423. *Id.* at 714. While the S-4 stated "that the merger hinged on obtaining regulatory approval" and "singled out that determining the effectiveness of its BSA/AML program would be crucial to obtaining that approval," "in '*every case* under the Bank Merger Act' the '[Federal Reserve] Board must take into consideration . . . records of compliance with anti-money-laundering laws.'" *Id.* M&T accordingly "offered information generally applicable to nearly any entity operating in a regulated environment." *Id.* at 715.

424. *Id.* at 714.

425. *Id.* at 715 (alteration in original) (quoting Seinfeld v. Becherer, 461 F.3d 365, 369 (3d Cir. 2006)).

426. *Id.*

427. *Id.* at 717–18.

428. *See supra* note 174 and accompanying text.

429. *Jaroslawicz*, 962 F.3d at 717 & n.16.

430. *Id.* at 717–18.

Significance and analysis. *Jaroslawicz* dissatisfies on two counts. First, M&T said in the supplemental proxy statement "that the Federal Reserve Board identified 'certain regulatory concerns' about 'procedures, systems and processes relating to M&T's Bank Secrecy Act and anti-money-laundering compliance program.'"[431] But that supplemental statement—though clearly "company-specific"—was not enough.[432] Perhaps M&T should have gone further and disclosed what the "certain regulatory concerns" were. Or perhaps the bank should have gone further and disclosed both BSA/AML compliance *problems* and the unconsented transfer of free checking accounts to fee accounts. But even this reading is clouded by the court's comment that "whether M&T had actual knowledge of the shortcomings in its BSA/AML compliance or its consumer checking practices is of no moment; it is the risk to the merger posed by the regulatory inspection itself that triggered the need for disclosures under Item 105."[433] It is hard to see that M&T failed to disclose that risk, given that it said expressly that (i) the Fed would have to clear the merger, (ii) the Fed would be evaluating AML compliance in that regard, and (iii) the Fed might not grant timely approval. Just exactly what M&T was supposed to disclose remains a mystery.

Second, the opinion displays doctrinal uncertainty. It notes that "[t]he parties do not argue that [SK Item 105] creates an independent cause of action," and then offers that "Item 105, if violated, constitutes a material omission or misrepresentation under the standards of Section 14(a) and its regulations."[434] Rule 14a-9 contains two prohibitions: against (i) misstatements of "material facts" and (ii) omission of material facts "necessary in order to make the statements therein not false or misleading."[435] *Jaroslawicz* deals with the second rather than the first[436]—so not any omission supports a violation, only an omission that makes other statements misleading. The theory may be that the generic language placed in the risk factor section of the prospectus misled because it purported to be a "risk factor" but was not. It would have been helpful if the Third Circuit had clarified.[437]

431. *Id.* at 707.

432. The Third Circuit rejected the argument that the supplemental proxy provided the necessary disclosure as a matter of law, leaving questions remaining as to the "lateness of its release *and the sufficiency of the information conveyed*." *Id.* at 715 n.14 (emphasis added). The court acknowledged that a registrant need only, per item 105, disclose risks of which it has actual knowledge. *Id.* at 713.

433. *Id.* at 716.

434. *Id.* at 711 n.10.

435. 17 C.F.R. § 240.14a-9 (2020).

436. Excepting here the portion of the *Omnicare* analysis addressing whether the opinions were false because the company did not hold them. *See supra* notes 427–30 and accompanying text.

437. 15 U.S.C. § 77(a) (2018). In another proxy statement case, the Fifth Circuit affirmed dismissal of a section 14(a)/Rule 14a-9 claim based on (i) the characterization in the proxy statement for an acquisition of an oil drilling services company that the deal premium was "significant" and (ii) projections of the target company's standalone revenue and EBITDA without projections of unlevered free cash flow based on an assumption of accelerating oil prices. Heinze v. Tesco, 971 F.3d 475 (5th Cir. 2020). In the course of the opinion, the court rejected the notion that a "pure omission" can support a Rule 14a-9(a) case, as the rule itself refers only to omissions that make the statements made in a proxy statement false or misleading. *Id.* at 483.

Tender offers. The issuer defendant in *Walleye Trading LLC v. AbbVie Inc.* ("AbbVie") conducted a self-tender to repurchase $7.5 billion of its shares in a Dutch auction to be conducted from May 1 to May 29, 2018.[438] It retained Computershare Trust Co. to receive and analyze the tenders.[439] On May 30, at 8 AM, "AbbVie announced the preliminary result: it would purchase 71.4 million shares for $105 per share (using the whole $7.5 billion pot when accounting for fees and expenses)."[440] Its traded stock price rose from $100 to $103 per share by the close that day.[441] About an hour after that close, "AbbVie announced that it had received corrected numbers from Computershare [and] . . . it would purchase 72.8 million shares at $103 a share, again adding to $7.5 billion."[442] The traded price of its stock fell the next day to $99 per share.[443] Affirming dismissal of a complaint alleging that AbbVie and an officer violated both Rule 10b-5 and Exchange Act section 14(e),[444] the Seventh Circuit found, as to the section 10(b) claim, that the plaintiff failed to allege a false statement because the first announcement "accurately reported Computershare's preliminary numbers."[445] Nor did the complaint allege scienter simply by claiming that the defendants did not check the preliminary figures themselves and that the defendants must have had the final figures some time before they disclosed them.[446] As to failing to check the preliminary numbers, "neither the statute nor any regulation requires an issuer to verify someone else's data before reporting them."[447] As to the time at which the defendants provided the final figures, while Computershare "must have provided the revised numbers to AbbVie before it issued the updated statement," "[n]either the statute nor any rule requires [the announcement of that information from the third party] to be done in seconds or minutes rather than hours," and here it would have taken some time to "put new numbers in a release and make them public" and would have taken more time if they were "checked and rechecked," as the plaintiff asserted the preliminary figures should have been.[448]

Turning to the tender offer statute, section 14(e) makes it "unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders."[449] Section 18(a) then provides an express cause of action to anyone who relied on a false or misleading

438. 962 F.3d 975, 977 (7th Cir. 2020).
439. *Id.*
440. *Id.*
441. *Id.*
442. *Id.*
443. *Id.*
444. *Id.* at 977, 979.
445. *Id.* at 978.
446. *Id.*
447. *Id.*
448. *Id.*
449. 15 U.S.C. § 78n(e) (2018).

statement in a document filed with the Commission.[450] Here, the plaintiff did "not try to show that AbbVie's statements were filed with the SEC or that [it] relied on them."[451] Moreover, AbbVie disclosed the preliminary figures after the tender offer had ended, and the Seventh Circuit "conclude[d] that an investor cannot use § 14(e) to challenge a statement made after a tender offer has closed."[452]

Significance and analysis. *AbbVie*'s holding that section 14(e) cannot be used to sue on a statement made after a tender offer is closed—even if the statement concerns the offer—restricts the application of that statute. Investors can still sue under Rule 10b-5 on a post-tender offer statement, but such a claim requires that the plaintiff plead and prove scienter. The circuits are now split on whether a section 14(e) claim requires scienter, with the Ninth Circuit holding it requires only negligence.[453]

Life sciences. So many cases last year arose out of the life sciences industry that this review groups them all together. The Ninth Circuit affirmed dismissal on the ground that a Rule 10b-5 complaint failed to include facts raising a strong inference of scienter where the plaintiffs alleged the device produced by the defendant had performed so poorly in Europe that the company and individual officer defendants must have known there was no chance of FDA approval, the court reasoning that it would have been irrational for the company to continue to express optimism in FDA approval if those in charge—who were not alleged to have sold the company's stock during the period of the purported fraud—had believed that the device would never be approved.[454] The Second Circuit vacated a dismissal in part, holding that the Rule 10b-5 complaint was sufficient insofar as it rested on an officer's alleged misrepresentation of survival rates in previous studies (not performed by the company) of pancreatic cancer patients and, relatedly, on the officer's statement of expected survival rates of such patients in the control group of the company's clinical trial.[455] The First Circuit affirmed dismissal where the shareholders sued a company alleging that it misrepresented compliance with current good manufacturing practices, concluding the complaint did not adequately allege scienter in large part because the company disclosed receipt of Forms 483 following FDA inspections and stated that resolving the problems the FDA found in the manufacture of the company's current products was a necessary condition for approval of a drug for which the company had submitted an NDA.[456] The First Circuit also affirmed dismissal of a section 11 claim, finding that the defendant device manufacturer had

450. *Id.* § 78r(a).
451. *AbbVie*, 962 F.3d at 978.
452. *Id.* at 979.
453. Varjabedian v. Emulex Corp., 888 F.3d 399, 404–08 (9th Cir. 2018), *cert. granted*, & *cert. dismissed*, 139 S. Ct. 1407 (Apr. 23, 2019) (mem.).
454. *See infra* notes 458–91 and accompanying text.
455. *See infra* notes 492–516 and accompanying text.
456. *See infra* notes 517–42 and accompanying text.

adequately disclosed in its IPO registration statement that, if its exoskeleton walker failed to prevent a fall, the user could be seriously hurt or die and that the FDA had ordered a post-approval surveillance study to provide reasonable assurance of safety, with the court also affirming dismissal of a Rule 10b-5 claim, finding no strong inference of scienter in the manufacturer's failure to disclose a September 2015 warning letter until February 2016, since the IPO registration statement had already said that failure to comply with the post-market surveillance requirement could lead to removal of the device from the market and other sanctions.[457]

Statements about FDA approval while device used in Europe. Endologix, Inc. ("Endologix") produced a stent-like device inserted into the aorta to seal off aneurysms.[458] The company began selling the device in Europe in 2013, after regulatory approval there, and Endologix sought FDA approval for sale of the device in the United States, which it could only obtain after a clinical trial.[459] Central to the events that followed was the possibility that the device might move, or "migrate," after insertion, to such an extent that it was no longer sealing the target aneurysm.[460]

As the U.S. clinical trial progressed, the defendants (the company and its CEO and CFO) (i) stated in May 2016 (at both a healthcare conference and in a press release) their expectation that the FDA would approve the device late that year or in the first part of 2017 and (ii) released later in May the data from the first year of the trial.[461] As conceded by the plaintiff, those first-year results "showed a '100% procedural technical success' and a 94% treatment success rate, achieving the FDA's primary safety and effectiveness endpoints," with a 2.3 percent migration rate.[462] The CEO said in August that the company "'remain[ed] very positive about the likelihood of approval'" and further that the questions from the FDA after it received the one-year data did not include any "'big surprises.'"[463]

On November 1, 2016, the company disclosed that, after analyzing the data again following the second year of the trial, Endologix was narrowing the set of patients for which it sought FDA approval for the device's use because the company had "'noticed an increase in migration in aneurysm enlargement in some patients with two-year follow-up'"—specifically those "'with small flow lumens and a lot of thrombus.'"[464] The CEO "indicated that the FDA 'had some questions about migration.'"[465] On November 16, 2016, the company announced that the FDA would not approve the device as quickly as the company

457. *See infra* notes 543–58 and accompanying text.
458. Nguyen v. Endologix, Inc., 962 F.3d 405, 408 (9th Cir. 2020).
459. *Id.* at 408–09.
460. *Id.* at 408.
461. *Id.* at 410–11.
462. *Id.* at 411.
463. *Id.*
464. *Id.*
465. *Id.* at 412.

had forecasted, with the earliest approval date now moved to the second quarter of 2018.[466] The Endologix stock price declined 20.5 percent that day.[467] The next day, the CEO said that while the one-year follow-up data showed only a 2.3 percent migration, the two-year data showed an increase and that that increase "'drove the discussion' with the FDA."[468]

The company announced on May 17, 2017 that it would no longer seek FDA approval for the device being tested but would concentrate on a second-generation model, which would not be approved until 2020.[469] The Endologix stock price dropped 36 percent that day.[470]

The plaintiff alleged that defendants' statements before May 17, 2017[471] violated Rule 10b-5, because "based on [the device's] performance in Europe, defendants 'knew that there was absolutely no hope of receiving FDA PMA approval by the end of 2016 or the first part of 2017' and knew 'the FDA would not approve [the device] for use in the U.S. because of the unacceptable safety risks device migration posed.'"[472] According to a confidential witness cited in the complaint, "European doctors in 2015 began sending Endologix a 'stream of complaints and incident reports' claiming that [the device] was migrating in their patients," the CEO and CFO were "'very involved,'" and this was the "'biggest thing we had going in the company.'"[473] At a non-public symposium in London on March 10 and 11, 2016—after the CEO approved a company presentation there "that documented the scope of the migration problem"—"an Endologix consultant stated that '[w]e are having some unexplained migrations, a lot of them[,]'" and "[a]nother Endologix representative admitted that the company had no solutions to the problem of . . . migration."[474] One vascular surgeon at the conference "also gave a presentation in which he stated that 'in a lot of cases' the devices were 'slipping' and 'moving.'"[475] The confidential witness said that he and others reported these concerns to the CEO.[476] In addition, a 2016 United Kingdom "case report 'warned of the ominous risks of migration' . . . and discussed one patient whose . . . device migrated eleven millimeters."[477] And a 2016 University of Liverpool report found 17 percent of the devices implanted in eighteen patients had migrated.[478]

466. *Id.*
467. *Id.*
468. *Id.*
469. *Id.*
470. *Id.*
471. *Id.* at 408–10, 413. The alleged fraud occurred between May 5, 2016 and May 18, 2017. Nguyen v. Endologix, Inc., Case No. 17-00017-AB (PLAx), 2018 WL 10321880, at *1 (C.D. Cal. Sept. 6, 2018).
472. *Nguyen*, 962 F.3d at 415.
473. *Id.* at 409.
474. *Id.* at 410.
475. *Id.*
476. *Id.*
477. *Id.*
478. *Id.*

The Ninth Circuit affirmed dismissal on the basis that the complaint failed to allege facts supporting the required strong inference of scienter.[479] The court pointed out that the May 2016 statements were supported by the one-year data that the company released in the same month.[480] When the company concluded that a two-year follow-up showed an increase in migration, the company disclosed that information on November 1, 2016, together with the more narrow patient population for the use in which Endologix now sought device approval.[481] It promptly disclosed later in that month the extended date for device approval.[482] All this raised the "plausible inference" "that defendants based their statements about FDA approval on the status and progress of the U.S. clinical trial."[483]

As to the facts alleged by the plaintiff, the report by the confidential witness of a stream of migration complaints from Europe failed to include "any details about these reports that would demonstrate a strong inference of scienter in Endologix's later statements."[484] And "[m]any of the statements that plaintiff alleges are false and misleading were made after [the confidential witness] left Endologix."[485] The University of Liverpool study employed a four-millimeter criterion for determining migration, whereas the FDA used a ten-millimeter yardstick, and the plaintiff did not "dispute the fact that, as the Liverpool study itself makes clear, applying the ten-millimeter metric there 'would have generated a zero rate of migration,' because all devices in the study migrated less than ten millimeters."[486] The U.K. study involved a single patient and, as for the London symposium, "[t]he complaint provides no explanation as to why a company supposedly bent on concealment in the United States would have open discussions with numerous company outsiders in Europe on the same underlying issue."[487]

Even more important than these details, the Ninth Circuit found the plaintiff's theory implausible overall.[488] Especially since there were no allegations that the defendants sought to profit from a temporarily inflated Endologix stock price—as by individual defendants selling their stock in the company during the period of the alleged fraud[489]—the theory offered no reason "why . . . defendants [would] promise the market that the FDA would approve [the device] if

479. *Id.* at 407–08, 419.

480. *Id.* at 419.

481. *Id.*

482. *Id.*

483. *Id.*

484. *Id.* at 417. The confidential witness did not "identify, for example, the number of European patients that experienced device migration, how much [the device] was migrating in these patients, whether the alleged device migration led to any further medical issues, whether the patients had particular conditions that exacerbated the migration, and whether the patients were within or outside either the original or revised [population of patients for which the company asked the FDA to approve device use]." *Id.* at 416.

485. *Id.* at 416.

486. *Id.* at 417.

487. *Id.*

488. *Id.* at 407–08, 415.

489. *Id.* at 415.

defendants knew the FDA would eventually figure out that [it] could not be approved due to 'intractable' and 'unresolvable' device migration problems."[490]

Significance and analysis. In most cases, the plaintiffs present a plausible case of fraud, and the defendants are left with attempting to contend that they have a *more* plausible benign explanation. But *Endologix* reminds us that defendants should always consider whether the plaintiffs' theory itself is implausible. *Endologix* also suggests that life sciences carefully define the terms they use and ensure that their public statements clearly signal definitions. It was important to the *Endologix* defendants that migration was defined for the U.S. study as movement of at least ten millimeters, whereas the Liverpool study on which plaintiffs relied defined migration as movement of just four millimeters.[491]

Descriptions of research performed by those outside the company. NewLink Genetics Corporation ("NewLink") sought FDA approval for a drug to treat pancreatic cancer patients following removal of cancerous tumors ("resection").[492] NewLink hoped that clinical trials would show that patients treated with its drug lived longer than resected pancreatic patients who were not. After Phase 2 trials, the President and Chief Medical Officer ("PCMO") told an audience of investors at a September 2013 biotech conference that "[r]esected pancreatic cancer patients live 15 months, 19 months. You can look at the last 30 years, all the major studies, pancreatic cancer survival—US-based studies, I want to make that distinction—survival rates come between 15 to 19, 20 months. That's it."[493] NewLink and the PCMO then stated on an investor call that "the Phase 2 trial results 'really exceeded any expectation that experts in the field had for what would happen in terms of one-year survival'" and constituted "'a very strong efficacy signal.'"[494] In March 2014, the PCMO said on an industry conference call that, in the Phase 3 trial—which involved both patients given the NewLink drug and a control group that was not—the company did not have "any reason to believe that median survival for [the control group] patients will be more than low 20s. Nevertheless, our study even though expectations were 18, 19 months, study is designed in the low 20s."[495] In July 2015—with the phase 3 trials ongoing and only interim results available—the PCMO, in an earnings call, "reiterated [the company's] belief that the median months for survival in the 'control arm [was] in the low 20s.'"[496] However, the final result for phase 3 "showed a median survival rate of 27.3 months

490. *Id.*

491. Making the same point, the Fourth Circuit affirmed dismissal of a Rule 10b-5 action brought against a manufacturer of a drug, finding no strong inference of scienter pled where the plaintiffs alleged the company misstated the drug's propensity to damage livers, but where the company and individual executive defendants had referred in their statements about such damage to a technical definition—Hy's Law—that participants in the company's clinical trials did not satisfy. Janies v. Cempra, Inc., 816 F. App'x 747 (4th Cir. 2020).

492. Abramson v. Newlink Genetics Corp., 965 F.3d 165, 169–70 (2d Cir. 2020).

493. *Id.* at 170.

494. *Id.* at 171.

495. *Id.*

496. *Id.*

for the test group, which was below the 30.4-month survival rate for the control group."[497]

Affirming in part and vacating in part the dismissal of a Rule 10b-5 claim brought by purchasers of NewLink stock based on these and other statements,[498] the Second Circuit held statements that the results of the Phase 2 trials "exceeded any [expert] expectations . . . [for] one-year survival" and provided a "strong" "signal" of "efficacy" constituted "puffery" that under circuit authority are "actionable only when the speaker 'knew that the contrary was true.'"[499] Here, the plaintiffs did not sufficiently plead that the defendants knew these statements were false because, "[a]s compared to the results of some studies of resected pancreatic cancer patients, the Phase 2 results arguably did show improvement."[500]

The court found other statements actionable. The September 2013 statement that "all the major studies, pancreatic cancer survival" showed "survival rates . . . between 15 to 19, 20 months," could be analyzed as either a statement of fact or—because it included a judgment of what studies were "major"—one of opinion.[501] But, since the investors pled that "[h]alf of the American studies that Plaintiffs submitted—all of which . . . an expert on pancreatic cancer[] described outside the context of this litigation as 'major'—preceded the September Statement and showed survival rates ranging from 25 months to 43 months," the "outcome . . . would not differ."[502] If seen as a representation of fact, the September 2013 statement could have "misled investors by implying that no credible studies [had] shown resected pancreatic cancer patients to have survival rates higher than 20 months," which would be false, given that the shareholders pled that "several studies, which Plaintiffs have plausibly alleged experts considered to be 'major,' did so."[503] Considered as an opinion and taking into account the "specificity of the representation" and the setting in which it was made—a "scheduled presentation at an important conference for biotech investors"—a reasonable investor "would have credited [it] as researched and intentional."[504] Ostensibly applying *Omnicare*'s[505] rule that an opinion can mislead if it "implies facts or the absence of contrary facts, and the speaker knows or reasonably should know of different material facts that were omitted,"[506] "a jury could

497. *Id.* at 172.

498. *Id.* at 169, 180.

499. *Id.* at 174 (quoting Novak v. Kasaks, 216 F.3d 300, 315 (2d Cir. 2000)).

500. *Id.* The court of appeals brushed aside allegations that the PCMO and the CEO sold stock during the Phase 3 trials as "this alone does not show that they disbelieved their generic, positive representations about [Newlinks' drug]. [The two executives] reasonably could have been selling stock to hedge against the risk of the Phase 3 trial failing, despite their belief that [the drug] showed promise." *Id.*

501. *Id.* at 170, 176.

502. *Id.* at 176, 177.

503. *Id.*

504. *Id.* at 177.

505. *See supra* note 174.

506. *Abramson*, 965 F.3d at 175.

conclude that the [PCMO's] confident statement and his omission of noted studies' findings were a bridge too far."[507]

On similar reasoning, the Second Circuit held that the investors had adequately pled the false or misleading nature of the PCMO's statement in March 2014 that the company did not have "any reason to believe that [the] median [number of months] survival for [the] patients [in the control group for the Phase 3 trials] will be more than the low 20s."[508] This statement "implied that there were no competing facts on survival rates" even though the plaintiffs alleged that "several studies show[ed] survival rates above 20 months."[509] Indeed, the company tried to enroll in the Phase 3 trials both patients with Stage I or Stage II pancreatic cancer,[510] and one of the studies that the PCMO referenced in his September 2013 statement "presented survival rates of 24.1 months and 20.6 months for Stage IA and IB patients."[511]

However, to the extent that the plaintiffs asserted that the defendants violated Rule 10b-5 by saying that they "designed" the Phase 3 trial with the notion that the control group would show survival rates in the "low 20s," the Second Circuit found no sufficient allegation of falsity, given that (i) the survival rate from the Phase 2 trials was 24.1 months, (ii) plaintiffs "argue[d] that, based on this Phase 2 survival rate, NewLink could at most have designed the Phase 3 trial with an anticipated 20.1-month survival rate for the control group," and (iii) that was "a figure in the low 20s."[512]

Significance and analysis. *NewLink* counsels careful pre-release review of any statements about studies that are not performed by the issuer—including academic studies. This may prove quite difficult when the life sciences company is attacking a disease that has been extensively investigated. Obviously, a company and its spokespersons generally should avoid—when describing such studies—stating that "all" or "none" of them or an "overwhelming majority" show a particular result. Beyond that, *NewLink* suggests that studies reaching a different

507. *Id*. at 177.
508. *Id*. at 171, 177–78.
509. *Id*. at 178.
510. *Id*. at 171.
511. *Id*. at 170.
512. *Id*. at 178.

The court also held, as had the district court, that the plaintiffs adequately alleged falsity of another statement, this one saying that the recruitment objective for the Phase 3 trials had been achieved, *id*. at 171, as the investors pled that a confidential witness "claimed to have witnessed the enrollment of ineligible individuals and to have raised concerns about the 'design' of the Phase 3 trial with [the PCMO]," *id*. at 178–79 (footnote and some internal quotation marks omitted). And the Second Circuit reversed the district court finding that the investors had failed to allege loss causation for this misrepresentation. *Id*. While the court of appeals concluded that an analyst Flash Note did not constitute a corrective disclosure because it "did not mention improper enrollment," the panel found that the plaintiffs had alleged loss causation through materialization of risk because "a sufficient number of improper enrollments would naturally and predictably affect a trial's statistical integrity," and the "higher survival rate [of the control group] than the test group by three months suggests as plausible that the pervasive enrollment of ineligible individuals may have affected the trial results." *Id*. at 180.

While the opinion extensively discusses the falsity of representations, it does not consider whether the plaintiff adequately alleged scienter.

conclusion than those a company cites may need to be particularly identified, if only by category. This should all depend on the particular way in which management describes previous research as well as on the weight of studies (number and quality) supporting and undermining the issuer's description.

Doctrinally, *NewLink* suffers two faults. First, the notion that the actionability of "puffery" depends on the subjective knowledge of those making puffing statements[513] confuses materiality (which is relevant to puffery) and scienter (which is not). If a statement is one that a reasonable investor would not consider in making a buy/sell decision, then it is not material and is inactionable, regardless of whether the speaker or author does not believe it to be true.[514] Second, the court's interpretation of *Omnicare* to mean that an opinion can mislead by omitting facts "the speaker knows *or reasonably should know*" is wrong too.[515] While *Omnicare* at one point says that an opinion can mislead when "the real facts are otherwise, but not provided," Justice Kagan then continues in the same paragraph to write that an opinion misleads in this way when the opinion does not "fairly align[] with the *information in the issuer's possession at the time*" and where the statement "omits material facts about the issuer's inquiry into or *knowledge*" about the opinion.[516]

Statements about compliance with current good manufacturing practices. In 2015, Ocular Therapeutix, Inc. ("Ocular") submitted an NDA seeking approval for use of its drug Dextenza to relieve pain following ophthalmic surgery.[517] In February 2016, as part of its consideration of the NDA, the FDA inspected the Ocular manufacturing facility to determine its compliance with current good manufacturing practices ("cGMP").[518] The FDA then sent a Form 483 to Ocular that included "ten observations detailing issues" with that facility.[519] In March 2016, Ocular filed a Form 10-K stating that the company "'fabricate[s] devices and drug depot products for use in our clinical trials, research and development and commercial efforts for all of our therapeutic product candidates using current [G]ood [M]anufacturing [P]ractices, or cGMP, at our multi-product

513. *See supra* note 499 and accompanying text.

514. The panel's citation to *Novak v. Kasaks*, 216 F.3d 300, 315 (2d Cir. 2000), *see supra* note 499, does not support the statement that the circuit "ha[d] found 'puffery' . . . actionable . . . when the speaker 'knew that the contrary was true.'" *NewLink*, 965 F.3d at 173–74. At the cited page, *Kasaks* expressly states that "puffery" is "insufficient" to support a claim and adds only that statements of fact such as "that the inventory situation was 'in good shape' or 'under control'" could create liability if the speakers "knew that the contrary was true." *Kasaks*, 216 F.3d at 315.

515. *See* text at *supra* note 506. *NewLink*'s full doctrinal statement is: "In other words, when a statement of opinion implies facts or the absence of contrary facts, and the speaker knows or *reasonably should know* of different material facts that were omitted, liability under Rule 10b-5 may follow." *NewLink*, 965 F.3d at 175 (emphasis added).

516. Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175, 188–89 (2015) (emphasis added). Justice Kagan goes on to say that she is talking about the case in which "an issuer *knows*, but fails to disclose, some fact cutting the other way." *Id.* at 189 (emphasis added).

517. Mehta v. Ocular Therapeutix, Inc., 955 F.3d 194, 199 (1st Cir. 2020).

518. *Id.*; 21 C.F.R. pt. 211 (2020) (defining cGMP). The facility manufactured "several drug products," including Dextenza. *Mehta*, 955 F.3d at 199 & n.4.

519. *Mehta*, 955 F.3d at 199.

facility.'"[520] In July, the FDA sent Ocular a Complete Response Letter ("CRL") rejecting the Dextenza NDA.[521] In November, Ocular's CEO said during an earnings call that "'we believe we have taken the appropriate steps to address the manufacturing[-]related items raised by the FDA, although the FDA will make its determination after we resubmit our NDA.'"[522]

In January 2017, the company disclosed that it had resubmitted the NDA, and in March 2017 it filed a Form 10-K, again stating that it "'fabricate[s] devices and drug insert and depot products for use in our clinical trials, research and development and commercial efforts for all of our therapeutic product candidates using current Good Manufacturing Practices, or cGMP, at our multi-product facility.'"[523] In May 2017, as part of reviewing the resubmitted NDA, the FDA conducted another inspection of the Ocular manufacturing plant and issued another Form 483, this one including six observations—at least two of which concerned particulate matter that appeared to include aluminum in manufactured lots.[524] The following day, Ocular's Executive Vice President of Regulatory, Quality, and Compliance ("EVPRQC") referred twice during an analyst conference call to the company's "fully developed manufacturing process."[525] In July 2017, the FDA delivered a CRL rejecting the resubmitted Dextenza NDA.[526]

Investors brought a Rule 10b-5 claim against Ocular and officers, alleging that they "had on multiple occasions intentionally or recklessly misled investors by making false statements and omitting material facts about Ocular's manufacturing problems and the impact those problems were likely to have on the FDA's approval of Dextenza."[527] The First Circuit affirmed dismissal.[528] The court of appeals held that the complaint failed to allege facts raising a strong inference of scienter[529] and divided its analysis into two parts—review of the company statements about compliance with cGMP in the two Form 10-Ks; and the statement in the May 2017 call that the company's manufacturing process was "fully developed."[530]

Turning to the Form 10-Ks, the First Circuit noted that in each of those two filings, the company "disclosed receipt of the February 2016 Form 483, described its relevance to Ocular's manufacturing capabilities, and warned of its implications."[531] Thus, for example, the 10-K filed in 2016 included the caution that "'[t]he failure to resolve the Form 483 inspectional observations from the February 2016 inspection could result in a delay in the [target] date [for FDA action on

520. *Id.* at 200 (alteration in original).
521. *Id.* at 201.
522. *Id.* (alteration added).
523. *Id.* at 201–02.
524. *Id.* at 202.
525. *Id.* at 203–04.
526. *Id.* at 204.
527. *Id.* at 205.
528. *Id.* at 198, 211.
529. *Id.* at 198.
530. *Id.* at 207–10.
531. *Id.* at 207.

the pending Dextenza NDA] and potential approval for the NDA.'"[532] The 10-K filed in 2017 "noted that in the CRL Ocular had received in July 2016, 'the concerns raised by the FDA pertain to deficiencies in manufacturing process and controls identified during a pre-NDA approval inspection of our manufacturing facility . . . in February 2016 that were documented on FDA Form 483.'"[533] And the 2017 10-K "stated that '[a]dequate resolution of Form 483 manufacturing deficiencies with the [FDA] is a prerequisite to the approval of the NDA for DEXTENZA.'"[534] The First Circuit held that, in light of "defendants' statements in the two Form 10-Ks that they produce multiple products at their Bedford manufacturing facility 'using' cGMP, and in light of the informative disclosures regarding the February 2016 Form 483, the more reasonable inference"—than the shareholders' one that the defendants acted with scienter—"is that defendants were stating their intention to comply with cGMP regulations as the governing standards for their drug product manufacturing operations."[535]

Turning to the statements in the May 2017 conference call that Ocular's manufacturing process was "fully developed," the company's CEO said in the same call that the company had received the May 2017 Form 483, and that it focused on particulate matter found during the May inspection.[536] Moreover, the EVPRQC referred expressly in the call to the new Form 483 and said that "'the [Form] 483 is something that we have to respond to.'"[537] To the First Circuit, those "disclosures regarding the May 2017 Form 483 made pellucid that Ocular's manufacturing process was considered deficient by the FDA and thus undercut any inference that [the EVPRQC] intentionally or recklessly misled investors by stating that Ocular's manufacturing process was 'fully developed.'"[538] Finally, the defendants contended that "fully developed," as applied to a drug manufacturing process, was a term of art defined by the FDA as "one that has surpassed the concept or piloting stage but must still be tested and validated to determine whether the process works as intended and meets the necessary standards."[539] "In light of that term of art and [the EVPRQC's] disclosures during the conference call that contravene plaintiffs' characterization of his statements, the more reasonable and compelling inference drawn from the complaint's allegations"—rather than an inference of scienter—was "that [the EVPRQC] spoke with nonfraudulent intent in describing Ocular's manufacturing process as 'fully developed.'"[540]

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532. *Id.* at 201 (quoting 10-K).
533. *Id.* at 202 (quoting 10-K).
534. *Id.* at 208 (alteration in original) (emphasis by the court removed) (quoting 10-K).
535. *Id.*
536. *Id.* at 209.
537. *Id.*
538. *Id.* at 210.
539. *Id.* (citing FOOD & DRUG ADMIN., GUIDE TO INSPECTIONS OF MEDICAL DEVICE MANUFACTURERS § 7 (2014), https://www.fda.gov/inspections-compliance-enforcement-and-criminal-investigations/inspection-guides/page-9 ("The process must be developed before it can be validated . . . .")).
540. *Id.* The court of appeals also observed that the CEO's purchase of Ocular shares during the class period was "consistent with our conclusion that plaintiffs have not alleged facts giving rise to a strong inference of scienter." *Id.* at 210 n.18.

Significance and analysis. The analysis of the statements in the Form 10-Ks suffers from semantic difficulty. The company said it was "using" cGMP at its manufacturing facility. It is a stretch to interpret this as simply "stating [the company's] intention to comply with cGMP."[541] More probably, the language on which the plaintiff focused was boilerplate. And a reasonable investor would not have taken the boilerplate as any kind of guarantee that Ocular was satisfying all FDA manufacturing requirements given that the company disclosed in the 10-Ks the first Form 483 showing that at least FDA inspectors examining the manufacturing facility did not agree. So perhaps the statements were not material. Alternatively, although this is a more challenging interpretation, perhaps the defendants knew that the blanket statements about "using cGMP" were not altogether true but nevertheless did not act fraudulently in including them in the SEC filings because they added the details showing it was wrong, at least in part.[542] In any event, companies should not rely on other courts concluding that a statement that a drug manufacturer "uses" cGMP is only a statement of intent, rather than a statement of current fact.

<u>Statements about device safety in registration statement and failure to disclose communications with the FDA regarding post-market surveillance for safety data.</u> ReWalk Robotics, Ltd. ("ReWalk") produced a robotic exoskeleton device for long-term home and community use to permit upright walking by persons with spinal cord injuries.[543] On June 26, 2014, the FDA approved it for marketing as a "class II medical device, meaning its use carries a medium risk requiring some 'special controls,' such as training and warning labels, to ensure safe operation."[544] The agency also required ReWalk to conduct post-market surveillance because (i) "'[the device's] failure to prevent a fall would be reasonably likely to cause user injury and/or death through fall'" and could harm someone trying to help the user maintain balance; and (ii) "'[t]he safety and effectiveness of the ReWalk has been demonstrated in an institutional environment (e.g. hospital, rehabilitation institution)'" but "'there is limited information on use outside of the institutional setting (e.g. community and at home use) . . . [and ReWalk] intends . . . the product[to be] use[d] in non-institutional settings.'"[545] Thereafter, "ReWalk missed deadlines for submitting plans for the post[-]market surveillance study, and the plans it did submit and revise were repeatedly deemed inadequate by the FDA," resulting in a September 30, 2015 letter from the FDA warning that "the device 'is currently misbranded under [the FDCA]' and threatening sanctions absent corrective action by ReWalk," which could include "seizure of the device,

541. *See supra* text accompanying note 535.

542. *See* Maguire Fin., LP v. PowerSecure Int'l, Inc., 876 F.3d 541, 548 (4th Cir. 2017) ("An inference that an executive had enough knowledge to be aware that he was making an inaccurate statement might support an inference that he made a material misrepresentation but does not necessarily suggest an intent to mislead.").

543. Yan v. ReWalk Robotics Ltd., 973 F.3d 22, 27 (1st Cir. 2020).

544. Wang Yan v. ReWalk Robotics Ltd., 330 F. Supp. 3d 555, 561 (D. Mass 2018) (date of FDA approval); *ReWalk*, 973 F.3d at 27 (quoting Federal Food, Drug, and Cosmetic Act ("FDCA") § 513, 21 U.S.C.A. § 360*c*(a)(1)(B)).

545. *Rewalk*, 973 F.3d at 27–28 (quoting FDA order) (citing FDCA § 522, 21 U.S.C. § 360*l*(b)(1)).

injunctions against its manufacture and sale, prosecution, and civil monetary penalties."[546]

When ReWalk disclosed the letter months later—at the end of February 2016—ReWalk's stock price fell by 13 percent.[547] A shareholder sued under section 11 of the Securities Act, alleging misstatements or omissions in the registration statement for ReWalk's IPO on August 26, 2014, and later amended the complaint to add a Rule 10b-5 claim based "primarily" on alleged misrepresentations and omissions after the offering.[548] The complaint did not allege that the FDA had taken any enforcement action against the company.[549]

Affirming dismissal,[550] the First Circuit rejected the claim that, while the Registration Statement disclosed the post-market surveillance that the FDA required, it misled because it "did not reveal that 'the FDA specifically determined, in June 2014, that the . . . device's failure to prevent a fall would be reasonably likely to cause serious injury or death to the user and place individuals assisting the user at the risk of harm from a potential fall.'"[551] The First Circuit reasoned that since (i) the registration statement stated the device was "an exoskeleton upon which a paralyzed user 'relies completely . . . to hold him or her upright[,]' . . . [(ii)] expressly noted that such a 'user could experience death or serious injury' were the device to malfunction," and [(iii)] disclosed that the post-market surveillance study would have "to 'demonstrate a reasonable assurance of safety,' . . . no reader would suspect that the FDA was concerned about mere bumps and bruises."[552] The court of appeals went on to observe that—contrary to the plaintiff's contention—the FDA had never made any finding "that the product 'was reasonably likely to cause serious injury or death,'" but had ordered the post-market surveillance simply because the agency, in light of its "incomplete knowledge" "on the 'rate and nature' of falls during home use," "wanted assurances of the device's safety," which is just what the registration statement revealed.[553]

546. *Id.* at 29 (alteration in original) (quotations from the FDA correspondence).

547. *Id.*

548. *Id.* at 29–31.

549. *Id.* at 29.

550. *Id.* at 27, 41.

551. *Id.* at 31.

552. *Id.*

553. *Id.* at 31–32. Rejecting the argument that the Registration Statement misled by characterizing the study as focusing on the device's safety in "urban terrain," the court observed that the plaintiff failed to "explain how this choice of language made the earlier warning language about death or injury in any setting misleading." *Id.* at 32. Rejecting the contention that the Statement misled by references to "compelling clinical data" demonstrating the device's success and its characterization of the device as a "breakthrough," the court found these inactionable puffery, *id.*; moreover, with respect to "breakthrough," the Statement "explain[ed] that the device is 'the only commercialized exoskeleton using a tilt sensor to restore self-initiated walking,' which [the shareholder] does not contest as untrue." *Id.* at 32–33. The court found no viable claim that the Statement violated Regulation S-K Items 303 and 503 (now recodified as Item 105) because the Statement said "that '[t]here is no long-term clinical data with respect to the safety or physical effects of [the device]' and that approval for use 'beyond the institutional/rehabilitational setting' requires performance of the relevant postmarket study," thereby adequately disclosing both uncertainty (relevant to Item 303) and risks (relevant to Item 503). *Id.* at 33–34. Finally, the First Circuit agreed with the trial court that representations such as "that ReWalk 'intend[s] to continue to work with [various entities] to generate additional data

Turning to the Rule 10b-5 claim,[554] the First Circuit held that it rested on Re-Walk's alleged "omissions . . . [of] run-of-the mill regulatory back-and-forths," which—taking into account the risk disclosures in the registration statement, failed to support a strong inference of scienter.[555] Only the failure to disclose the September 2015 warning letter until February 2016 warranted specific attention.[556] But the court could not infer scienter from that circumstance because (i) the registration statement had "already disclosed that '[f]ailure to comply with the [post-market surveillance study, among other things] could lead to removal of ReWalk from the market' and that 'fail[ure] to comply with applicable regulatory requirements . . . may result in' seizures, injunctions, and civil penalties"; (ii) the complaint included no facts suggesting a motive for the defendants to lie (e.g., stock sales during the period of the alleged fraud or bonuses dependent on the company's stock price during that period); and (iii) the plaintiff included "no allegation that defendants regarded the warning letter as calling on ReWalk to do what it did not intend to do."[557] Indeed, the complaint itself "actually suggest[ed] . . . [t]hat even after receiving the warning letter, defendants believed they could still meet the FDA's requirements, as they showed 'no sense of urgency' regarding the study until February 2016—exactly when they disclosed the warning letter to investors."[558]

Significance and analysis. *ReWalk* illustrates the difficulty companies encounter as they try to determine the materiality of a communication with the FDA referring to possible draconian sanctions. It may help to use the probability/magnitude construct developed to determine the materiality of a current event by the probability that it foreshadows a future event and the magnitude of that future event. The subjective judgment of management as to whether the warning from the FDA is likely to foretell some crippling sanction should also be relevant to scienter.

Miscellaneous. Based on, among other things, their formal power under the operating agreement, their access to information, and their industry and overall business experience, the Tenth Circuit held that interests plaintiffs bought in a limited liability company were neither "investment contracts" nor "certificate[s] of interest

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regarding functionality and that supports the health and economic benefits of [the device]' and that it will 'continue to engage and fund researchers and organizations to conduct clinical studies to demonstrate the functionality and utilization of ReWalk and to highlight economic benefits of reductions in medical complications associated with spinal cord injury'" were forward-looking statements protected by 15 U.S.C. § 78u-5(c)(1)(A)(i), (i)(1), because accompanied by such meaningful cautionary language such as "that 'future studies or clinical experience may indicate . . . treatment with [the device] is not superior to treatment with alternative products or therapies' and . . . insurers may never provide coverage for these devices due in part to their 'experimental' nature backed by 'limited clinical data.'" *Id.* at 34–35.

554. The First Circuit (i) agreed that the plaintiff had no standing to bring the Rule 10b-5 claim based on statements made after the IPO because the plaintiff had not bought after the offering, *id.* at 35, (ii) held that the plaintiff did have standing to move to amend the complaint to add a plaintiff who had purchased during that period, *id.* at 36–39, but (iii) affirmed the denial of the motion on the ground that it would have been futile because the complaint pled no adequate Rule 10b-5 claim, *id.* at 39.

555. *Id.* at 40.

556. *Id.*; *id.* at 29 (discussing the date of disclosure).

557. *Id.* at 40–41.

558. *Id.* at 41.

or participation in any profit-sharing agreement," as the federal definition of "security" employs those phrases.[559] Both the Sixth and Third Circuits affirmed summary judgments in favor of investment advisers sued by shareholders in funds who contended that the fees the advisers charged violated the fiduciary obligation imposed by Investment Company Act section 36(b), with the shareholders basing their contention on the advisers charging the funds in which they invested more than the advisers charged funds that retained them in a sub-advisory role.[560]

The Second Circuit held that an investment adviser's client, who had given the adviser discretion to invest the client's money, was not a member of a "group" including other such clients and the adviser for purposes of determining Exchange Act section 16(b) short-swing profit liability by a group beneficially owning more than 10 percent of an equity security registered under Exchange Act section 12.[561] In another section 16(b) case, the Second Circuit vacated a summary judgment against a defendant fund for $4,909,393, remanding to determine whether the investment management agreement—which delegated buy/sell decisions to an adviser and included a sixty-one-day notice of termination that could have taken the fund outside the definition of beneficial owner per Rule 13d-3(d)(1)(i)—could have been amended to remove or shorten the notice period by the single individual who had signed the contract on behalf of the fund, its feeder funds, and the adviser.[562]

The Third Circuit held that, in order for a defendant to successfully invoke the non-imprisonment clause in Exchange Act section 32(a), the defendant must show by a preponderance of the evidence that he or she did not know the substance of the law the defendant violated and that a defendant in an insider trading case brought on the misappropriation theory had failed to make that showing, given that (i) he was an experienced trader, (ii) he and his confederates had received emails saying that the information in them was confidential and that its use was restricted, and (iii) he actively attempted to conceal his trades based on that information.[563]

The Eleventh Circuit affirmed an order enforcing SEC administrative subpoenas, holding that they can reach entities not named in the Formal Order of Investigation ("FOI"), entities not formed at the time the FOI issued, and persons and entities identified by second- and third-level leads in an ongoing investigation that continues for years after the FOI issues.[564] The D.C. Circuit held that a permanent bar from membership in FINRA and association with any FINRA member firm was not a "penalty" and therefore not "excessive or oppressive" as 15 U.S.C. § 78s(e)(2) uses that phrase, because FINRA imposed that sanction to protect investors.[565]

559. Foxfield Villa Assocs., LLC v. Robben, 967 F.3d 1082 (10th Cir. 2020), *cert. denied*, No. 20-868, 2021 WL 666461 (U.S. 2021) (mem.).

560. Goodman v. J.P. Morgan Inv. Mgmt., Inc., 954 F.3d 852 (6th Cir. 2020); *In re* BlackRock Mut. Funds Advisory Fee Litig., 816 F. App'x 637 (3d Cir. 2020).

561. Rubenstein v. Int'l Value Advisers, LLC, 959 F.3d 541, 544 (2d Cir. 2020).

562. Packer v. Raging Cap. Mgmt., LLC, 981 F.3d 148 (2d Cir. 2020).

563. United States v. Fishoff, 949 F.3d 157, 160, 168 (3d Cir. 2020).

564. SEC v. Marin, 982 F.3d 1341 (11th Cir. 2020).

565. Saad v. SEC, 980 F.3d 103 (D.C. Cir. 2020).