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Inside

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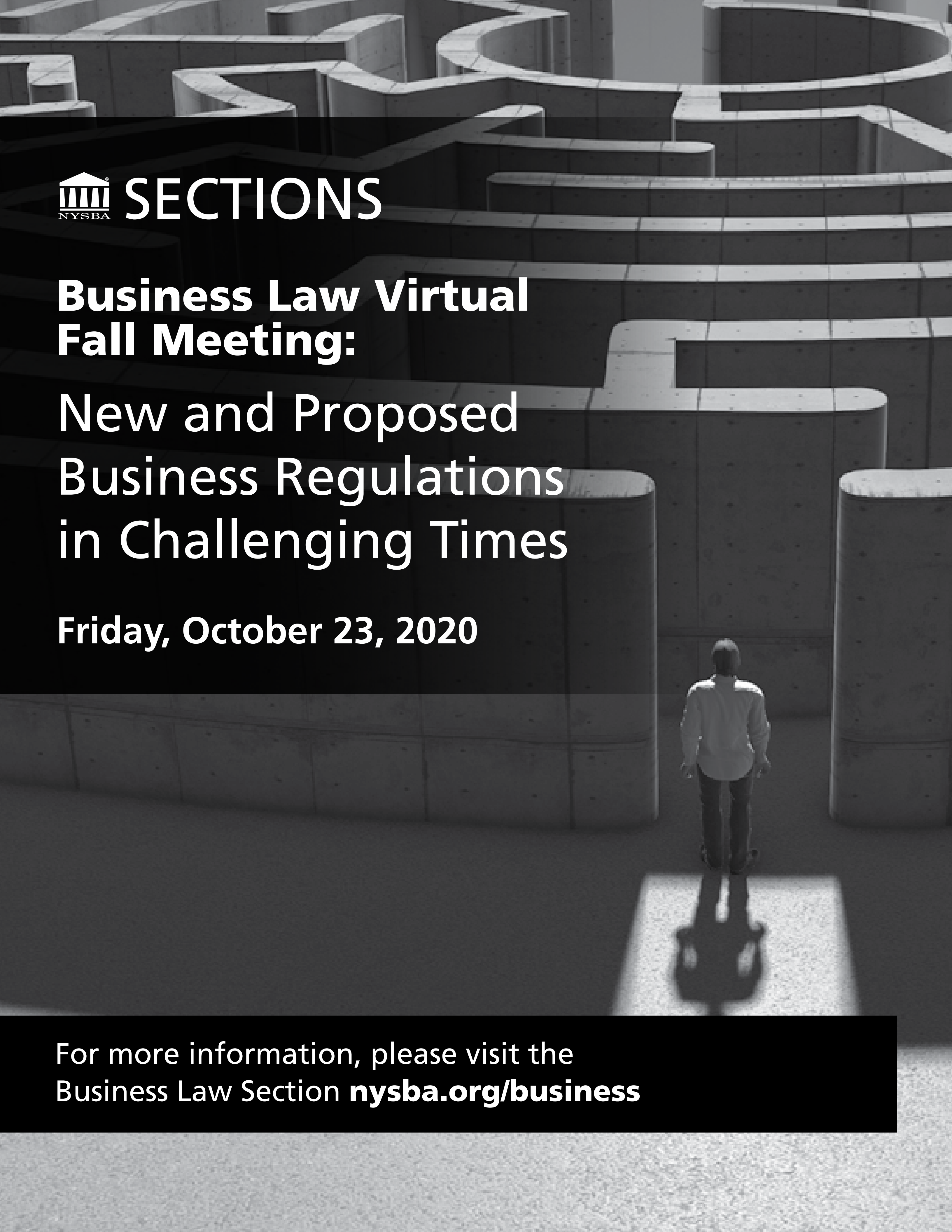
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Report from the Outgoing Section Chair

What does the world look like as you read this?

As I sit in my home office writing this on March 20, 2020, the governor has just announced that all nonessential businesses in the State of New York effectively must shut down their workplaces. I can't tell from here whether the current situation will have improved or, I fear more likely, have worsened by the time this is published. I do know that we live in a challenging time—challenging for each of us, both personally, with concerns for the health and safety of our families and friends, and professionally as business lawyers, as we counsel our clients in a rapidly changing world of government directives, employment law mandates, and public health advice.

I also know that one of the best sources for current information in the last week has been the Business Law Section and the New York State Bar Association. This week alone, the governor issued a sequence of daily executive orders requiring 50%, then 75%, and today 100% of workforces to work remotely or not at all, and provided for banks to permit mortgage payment deferrals in cases of financial hardship. The New York Department of Financial Services has issued a series of directives to financial institutions addressing COVID-19 issues. As this has been happening, the Business Law Section Communities on the NYSBA website have been a source of up-to-the minute accurate information. Indeed, I was able immediately to answer an urgent call from a client this morning because of information in a Section Community post about today's executive order. (By the way, if you want to get the full benefit of these updates, you need to make sure you are subscribed to the Business Law Section's main Community, and the Communities of the various Committees relevant to your practice, and that you select real time emails, rather than one of the less frequent options. Follow the Communities link at the top of the NYSBA home page.)

NYSBA has also reached out to the Section to produce on short notice a series of webinars addressing legal issues for businesses raised by COVID-19. We have responded quickly, already having produced a webinar on "Coronavirus—What Businesses Should Do To Prepare" that was made available free to the entire NYSBA membership on March 16, 2020. That webinar reached the NYSBA CLE maximum capacity of 500 registrants before being closed to more, and is now available on demand. We will be presenting another webinar on March 24 on "The Pandemic Is Beyond Your Control—But Is It Force Majeure?" And we are planning additional possible programs in the near term on restructuring issues that companies may face in light of COVID-19; the role of in-house counsel; cybersecurity concerns; virtual shareholder meetings; and sustaining a practice in the face of the current circumstances.

Drew Jaglom

In short, the Business Law Section has been and intends to continue to be a valuable resource to business lawyers in serving their clients, and staying current in a world that is changing even more rapidly than ever. And at the same time, we are continuing to comment on pending legislation, and to make legislative proposals. Once we are able again to gather together, we will resume holding meetings that offer cutting-edge CLE, valuable networking, and the opportunity to make friends and colleagues of some of the finest business lawyers around. We hope to start with rescheduling our recently canceled meeting on emerging issues in corporate governance in Mystic, Connecticut together with the Connecticut Bar Association Business Law Section and the NYSBA Corporate Counsel Section.

If you are not already active in the Section, please join us. We have lots of opportunities to participate, and you have lots to gain by doing so. In the meantime, keep yourself and your loved ones healthy and safe.

Drew Jaglom's term of office ended as of July 1. He was succeeded by Anthony Fletcher as Chair of the Section. Mr. Fletcher's report will appear in the next issue.

HeadNotes

As this issue was going to press, the coronavirus pandemic was at its height, and New York was among the states hardest hit. The state has responded in a variety of ways. In late March Governor Cuomo issued an Executive Order, essentially mandating that banks and other lenders licensed or chartered by the state provide three months forbearance on payment of a residential mortgage, and waive certain fees, for individuals suffering "financial hardship" as a result of COVID-19. The Superintendent of the State's Department of Financial Services (DFS) has the power under state law to act against banks engaged in "unsafe and unsound" practices; the order essentially defines a lender's refusal to lend to a distressed borrower as "unsafe and unsound"—seemingly turning the meaning of that phrase upside down—while at the same time lenders are expected to consider their own safety and soundness concerns in deciding whether to grant forbearance. Clearly a difficult juggling act, and just another sign of the extraordinary times in which we are living; but lenders are probably well advised to grant forbearance liberally, if hardship can be shown.

The DFS shortly thereafter issued an emergency regulation to implement the order. The regulation requires covered lenders to make application forms readily available on a borrower's showing of "financial hardship" directly attributable to COVID-19. They must clearly spell out the criteria for forbearance, and act on applications within ten days. New York business attorneys, whether representing lenders or borrowers, need to be mindful of the availability of this remedy. Although national banks and federal thrift institutions are not covered, the federal regulators have implemented a number of measures to encourage the institutions they regulate to work with distressed borrowers. Taking a carrot rather than stick approach, they have made clear that institutions that grant forbearance will receive favorable regulatory accounting treatment and credit under the Community Reinvestment Act (CRA), which mandates that banks serve the needs of their local communities.

As with the virus itself, legal developments pertaining to COVID-19 are proceeding too rapidly to allow for timely coverage in the *Journal*. In the meantime, New York business lawyers and their clients continue to face the usual wide range of other challenges. Leading off this issue the *Journal*'s ethics guru, Evan Stewart, presents yet another in his long-running series of cautionary tales for lawyers. In "Lawyer Liability: In the Crosshairs, Again!" he reviews the latest attempt by the Securities and Exchange Commission (SEC) to expand liability by including not just the makers of false and misleading statements, but acts by others—including lawyers —who allegedly aid and abet securities fraud by their clients. In *Lorenzo v. SEC*, decided by the Supreme Court last year, the Court seemingly overrode its prior precedents, which confined liability to the "maker" of the false and misleading statement, to include one who "disseminates" that statement. In his usual clear and entertaining manner, Mr. Stewart first reviews the prior case law, then explains how the *Lorenzo* decision raises the specter of liability for securities lawyers. Mr. Stewart is a partner in Cohen & Gresser, a member of the *Journal*'s Advisory Board, and a highly respected expert on issues related to attorney ethics.

David L. Glass

Our next two articles focus on practical issues encountered by business lawyers in advising their clients. In "Practical Tips for Drafting Agreements From 'Whole Cloth'," Joseph Cuomo and Keith Belfield address the dilemma of the contract lawyer who is asked to prepare an agreement for which there is no clear precedent or starting point—and, of course, the client needs the agreement "yesterday." If you find yourself in this position, don't panic—follow the step-by-step approach laid out by the authors: start with the client's "vision"; search anywhere and everywhere for a "lump of clay" —a rough model to start with; and mold and polish the draft, using bits and pieces as relevant from the models you've found. Mr. Cuomo is a partner and chairperson of the Corporate and Mergers & Acquisitions Group of Forchelli Deegan Terrana, based in Uniondale.

Attorneys who regularly advise business owners might find themselves asked to advise on the possible sale of that business. In the past this was most likely to arise when the owner was nearing retirement age. But with the growth of the private equity market, there may be a whole host of new considerations influencing the timing of such a sale. In "Is This the Right Time to Sell My Business?" Stuart Newman notes that the wide availability of capital looking for investments makes it a seller's market at present. He lays out some practical considerations that the attorney should have in mind when advising her client as to whether the time is right. Mr. Newman, a partner in Offit Kurman, is Chair Emeritus of the *Journal*'s Advisory Board and a regular contributor.

California has always prided itself on leading the way in consumer protection measures. The California Consumer Privacy Act (CCPA) is the latest example. Enacted in 2018, the law took full effect in July 2020, and provides comprehensive protection for consumers' non-public information in a wide variety of contexts. However, the law does exempt those financial institutions that are subject to the privacy provisions of the federal Gramm-Leach-Bliley Act (GLBA) of 1999. In "The CCPA Is Here: What Financial Institutions Need to Know About the California Consumer Privacy Act," David Oberly and Tanweer Ansari explain the GLBA carve-out from the requirements of the CCPA. The issue arises because the term "non-public personal information" in GLBA has been interpreted to mean only information obtained in the context of a financial transaction; the CCPA applies more broadly. The authors explain how the two interact and lay out some practical compliance strategies for financial institutions. Mr. Ansari is Senior Vice President and Chief Compliance Officer of First National Bank of Long Island and is a past chair of the Section's Banking Law Committee.

One of the major reforms in the Dodd-Frank Act of 2010, enacted in the wake of the global financial crisis, was the so-called "Volcker Rule," named for the respected former Chairman of the Federal Reserve ("Fed") who first proposed it. In principle, the rule is simple: banks that are insured by the Federal Deposit Insurance Corporation (FDIC) or that have access to Federal Reserve credit should not be allowed to engage in trading for their own accounts ("prop trading") or invest in funds, such as hedge funds ("covered funds"), that do so. But as always the devil is in the details; as originally implemented by the five responsible agencies—the Fed, the FDIC, the Office of the Comptroller of the Currency (OCC), the SEC, and the Commodity Futures Trading Commission (CFTC) —the Volcker Rule was massively complex, taking up 297 pages of three-column fine print in the Federal Register. In 2019, following the enactment of authorizing legislation by the Congress, the agencies issued revised rules, intended to simplify and streamline the prop trading rules. On January 30 of this year, they issued a proposal to do the same with respect to covered funds. In "U.S. Agencies Proposed Revisions to Volcker Rule Covered Fund Provisions," the attorneys of Mayer Brown, led by partners Carol Hitselberger, Thomas Delaney, and Jeffrey Taft, discuss and analyze the proposed changes which, among other things, provide relief for certain foreign funds; ease compliance burdens for loan securitizations, foreign public funds, and small business investment companies; create certain new exclusions; and narrow the scope of the definition of "ownership interest." Their clear and comprehensive overview is essential reading for lawyers who represent funds or banks, as well as any lawyer seeking to understand this complex area of law.

Foreign issuers seeking to sell securities in the U.S. face unique challenges. In "Foreign Private Issuers: Annual Report Issues to Look For in 2020-21," attorneys Guy Lander, Steven Glusband, and Guy Ben-Ami highlight the matters that such issuers should be focused on addressing, based on perceived trends in SEC staff concerns. Their article was written before the coronavirus outbreak, so it does not address that issue, which undoubtedly will loom large; but it does lay out other significant risk factors, ranging from the possibility of a trade war with China, through cybersecurity, Brexit, and the phasing out of the London Interbank Offered Rate (LIBOR) as the standard benchmark for a wide range of transactions. They also discuss various SEC proposals to simplify reporting requirements, expand the definition of "accredited investor," and modernize disclosures of business, legal proceedings, and risk factors. Messrs. Lander and Glusband are partners and Mr. Ben-Ami is Counsel with Carter, Ledyard & Milburn in New York; Mr. Lander is a past Chair of the Business Law Section and a current member of the *Journal*'s Advisory Board.

"Lenders are probably well advised to grant forbearance liberally, if hardship can be shown."

One of the satisfactions of serving as editor of the *Journal* is the opportunity to recognize and reward outstanding student contributions received through our Annual Student Writing Competition. With great pleasure we announce the winners of the Competition for 2019—all three of which appeared in the Summer 2019 issue of the *Journal*.

First prize, including a check for $2,000, goes to Katherine A. Cody, a student at St. John's School of Law, for her article, "Critical Audit Matters: Improving Disclosure Through Auditor Insight." A licensed CPA, Ms. Cody discusses the significant changes to the independent auditors' report to include "critical audit matters" as well as the traditional "pass/fail" auditors' opinion. Second prize, including a check for $1,500, goes to Kei Komuro, a student at Fordham Law School, for his thorough and insightful "Challenges and Implications for Potential Reforms of Crowdfunding Laws for Social Enterprises." Third prize and a check for $1,000 is awarded to Danielle Kassatly, a student at UC Davis School of Law, for "The Patentability of Technology in the Information Age: How the Checks and Balances of the Courts in a Patent Suit Pathway Stimulate Innovation in the Field of Artificial Intelligence." We congratulate all our winners—and thank them again for their outstanding contributions to the *Journal*.

Which brings us to this issue's next article, "Securities and Commodities Market Regulation of Latency Arbitrage," by Anthony Macchiarulo, a student at New York Law School. The term "latency arbitrage" refers to the practice of capitalizing on the time delay resulting from purchasing securities or commodities across different exchanges. In the modern markets, sophisticated high frequency trading (HFT) computer algorithms are able to detect small price disparities for the same security or commodity on different exchanges, and to simultaneously buy at the lower price and sell at the higher one. The so-called "flash crash" of 2010, in which the Dow Jones Industrial Average fell over 1,000 points in several minutes and then rebounded, led to greater regulatory scrutiny of HFT. In his thoroughly researched and analytical article, Mr. Macchiarulo reviews the subsequent case law and changes in the markets—and manages to do so in language even an attorney can understand!

In the federal Agricultural Improvement Act of 2018 (the "Farm Bill"), hemp was removed from the definition of "marijuana" under the Controlled Substances Act, thereby enabling the legal production of industrial hemp—even as marijuana remains illegal at the federal level. The law defines "hemp" as having a concentration of less than 0.3 percent of THC, the primary psychoactive component of marijuana, and thus distinguishes it from illegal marijuana. Among the effects of the law are the now widespread availability of CBD, a derivative of hemp that is believed to have various health benefits. However, the production of industrial hemp remained hampered by conflicting state laws and the lack of guidance from the Department of Agriculture (USDA). In "Industrial Hemp: U.S. Department of Agriculture Publishes Interim Final Rule to Implement 2018 Farm Bill Program," Guy Lander, Alexander Malyshev, and Anup Khatri of Carter, Ledyard & Milburn discuss and analyze the interim final Rule issued by the USDA in late 2019. Under the rule, any person seeking to produce hemp must first be licensed, either under a USDA-approved state or tribal plan, or the federal plan administered by the USDA, which applies in states and tribal territories that do not have a USDA-approved plan and have not otherwise outlawed hemp production. The substantive requirements, laid out in the rule, are generally the same under both options.

New York has long sought to be the forum of choice for the resolution of international disputes. In 2011, the New York State Bar Association endorsed this position in its task force report on New York law in international matters. But in the franchise area, the New York Franchise Act (NYFA) effectively discourages international franchising in the state. In "How New York Can Be a Center for International Franchising," Thomas Pitegoff reviews the statutory and case law, showing how the NYFA has extraterritorial reach and broad application in international law. He then explains how two changes in the law, both endorsed by NYSBA, could substantially enhance the attractiveness of New York as a center for international franchising. Mr. Pitegoff is a Principal of Offit Kurman and a past Chair of the Business Law Section's Committee on Franchise Law.

No issue of the *Journal* would be complete without "Inside the Courts," an exhaustive yet cogent review of substantially all litigation currently pending in the federal courts that impacts on corporate or securities law. It is required reading not just for litigators, but for all business attorneys in New York who need to keep abreast of changes in the law to advise their clients. As always, we are indebted to the attorneys of Skadden, Arps, Slate, Meagher & Flom LLP for their generosity in sharing their knowledge and insights with our readers.

Lawyer Liability: In the Crosshairs, Again!

By C. Evan Stewart

Yogi Berra really did say: "It's déjà vu all over again!"[1] Three times the U.S. Supreme Court has held that there is no aider and abettor liability for secondary actors (e.g., lawyers); that to establish a 10b-5 claim under the '34 Act, the traditional elements of fraud/tort (defendants must speak; plaintiffs must show reliance; etc.) must be pleaded and proven.[2] The Securities and Exchange Commission has never really taken "no" for an answer, however, and has continually tried to work a way around it.[3] The Commission recently went at it again, for a fourth time; this time in a case encaptioned *Lorenzo v. S.E.C.*[4] Oral argument took place at the Supreme Court on December 3, 2018; and a decision came down March 27, 2019. *Lorenzo* is an important case for many reasons, and it deserves our full attention.

First, Some Context

Before diving into *Lorenzo,* it is important to provide some context for the history of seeking to hold secondary actors accountable for fraud. *Barker v. Henderson*[5] is a good starting point; it was one the first cases to examine an attorney's duties (and liabilities) in detail. In *Barker*, a Michigan religious foundation issued unregistered bonds to unsophisticated investors, who ended up taking a bath. Searching for deep pockets, the plaintiffs' lawyers sued, among others, the foundation's lawyers. Two law firms had been hired specifically to review the bonds' selling materials and to advise the foundation on securities law issues; those two firms wrote settlement checks. Left in the litigation was the foundation's regular legal counsel, who did not have expertise in securities matters but who also neither blew the whistle on their client nor did anything to stop the sale of the bonds (even after receiving the selling materials).

On behalf of a panel of the U.S. Court of Appeals for the Seventh Circuit, Judge Frank Easterbrook rejected claims that the law firm had aided and abetted fraud. Judge Easterbrook found it factually significant that the firm had not been consulted on any securities issues; there was no evidence, moreover, that the firm had seen any of the selling materials until after they were being utilized. With respect to the law firm's silence in the face of their client's actions, Judge Easterbrook wrote that the lawyers were not "required to tattle on their clients in the absence of a duty to disclose." And because there was no such duty under prevailing professional responsibility rules, he ruled that:

> [A]n award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal . . . profession[ ]. Liability depends upon an existing duty to disclose. *The securities laws must lag behind changes in ethical and fiduciary standards*. [emphasis added]

In the aftermath of Judge Easterbrook's pronouncement that liability under the securities laws had to "lag behind" changes in lawyers' professional obligations came a number of important (and perhaps confusing) decisions. In *Schatz v. Rosenberg*,[6] for example, a law firm represented a fraudster. At the closing of a deal, the law firm handed to the other side a document its client had prepared, in which the client represented that nothing material had changed with respect to his financial condition. The representation was false, and the law firm knew it was false.

After the deal cratered (because of the client's true financial condition), the other side sued the law firm under multiple theories of fraud. The U.S. Court of Appeals for the Fourth Circuit, however, ruled that the law firm had no liability. How could this be?!

First off, Judge Robert Chapman, writing for a unanimous Fourth Circuit, addressed the claim that the firm was a primary violator of Rule 10b-5 fraud (i) by failing to disclose its client's misrepresentation, and (ii) by making affirmative misrepresentations of its own about the client's financial condition. With respect to the former, Judge Chapman determined there was no duty to disclose under the federal securities laws or applicable state law; he further ruled that there was no public policy in favor of disclosure (in fact, public policy would be in favor of non-disclosure, so as to enhance lawyers' fact-finding abilities).[7]

As to affirmative misrepresentations, Judge Chapman determined that the firm had made no independent representations of its own, but had only passed on its client's; put another way, the other side's reliance was on the client's misrepresentations, not on anything said or written by the law firm (which had "merely 'papered the deal,'" and whose role was only that of a "scrivener").

With respect to the claim of aiding and abetting fraud, Judge Chapman gave it short shrift. The law firm did not have the requisite scienter to abet the fraud because the firm owed no duty to the other party to the deal (which was represented by its own counsel). And the law firm did

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not provide "substantial assistance" to its client's fraud for the same reasons it was not a primary violator in the fraud.

In 1994, the U.S. Supreme Court stepped into this fray in *Central Bank of Denver v. First Interstate of Denver*.[8] There, the Court held that since the text of §10(b) does not cover those who aid and abet a §10(b) violation, private plaintiffs seeking money damages could not bring an aiding and abetting claim against a secondary actor. At the same time, the *Central Bank* Court left open that (i) criminal liability for aiding and abetting was still viable, (ii) an SEC enforcement action based upon aiding and abetting was still viable, and (iii) traditional secondary actors in the capital markets (e.g., lawyers) could be pursued by private plaintiffs as primary violators "assuming all of the requirements for primary liability under Rule 10b-5 are met."

Just as lawyers began to think the water was safe into which to wade, the third door left ajar by the Supreme Court was pounced upon by the plaintiffs' bar, and there began a wave of new cases, premised upon lawyers (or other secondary actors) being held to the same standard of accountability for fraud as their clients. This attack seemed to reach its height/nadir in *Klein v. Boyd*.[9]

In *Klein*, the plaintiff (supported by the Securities and Exchange Commission) argued, and a panel of the U.S. Court of Appeals for the Third Circuit agreed, that a law firm could be held liable as a primary violator of securities fraud, even where the lead lawyer did not sign the document(s) at issue and where the investor was never aware of the lawyer's role in the creation of document(s). In the Third Circuit's view, the law firm was a primary violator because it "elect[ed] to speak" by its authoring or co-authoring of document(s) with alleged material misrepresentations and/or material omissions; according to the Third Circuit, while the firm did not have an obligation to blow the whistle on its client, it did have a duty to correct its own "statements."

On an *en banc* review, the SEC made its position even clearer: a law firm should be held accountable for fraud where it helps to "create" a misrepresentation. Prior to a ruling by the entire Court of Appeals, the case was settled; but the original precedent lived on, with the SEC (and the plaintiffs' bar) continuing to espouse such theories of liability, especially in the aftermath of Enron and similar corporate train wrecks.

In the aforementioned corporate train wrecks' aftermath, various courts reached different results as to lawyers' duties to "speak" to third parties.[10] These different results (and disparate outcomes on the issue of secondary actor liability) ultimately became so profound that the Supreme Court in 2008 agreed to revisit the same ground it had gone over in *Central Bank*. In *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*,[11] the Court (i) re-affirmed its prior ruling in *Central Bank* (noting that Congress had explicitly declined to establish aiding and abetting liability for civil suits when it had passed various securities legislation since 1994), and (ii) rejected the concept of "scheme liability"—a theory consistent with the *Klein v. Boyd* court's rationale—because it failed to require a basic element of a cause of action for fraud (i.e., that the aggrieved plaintiff(s) relied upon some act or omission by an alleged primary violator defendant(s).[12]

Three years later, the Supreme Court felt compelled to weigh in once more, this time *in Janus Capital Group, Inc. v. First Derivative Traders*.[13] In that case, Janus Capital Group (JCG) was sued for allegedly making misleading statements in various of Janus funds' prospectuses. Although the district court dismissed the complaint, the Fourth Circuit reversed, ruling that even if JCG had not actually written the alleged statements in the fund prospectuses, one of its subsidiaries (Janus Capital Management/JCM) must have approved those statements (actually made by a different corporate entity in the Janus family—Janus Investment Fund/JIF) (JIF is a separate legal entity owned entirely by mutual fund investors).

Writing for a five Justice majority, which reversed the Fourth Circuit, Justice Clarence Thomas held that the "maker" of a statement is "the person or entity with ultimate authority over the statement"—in this case JIF, citing the Court's prior ruling in *Central Bank*. He further observed that to give "make" a broader meaning would substantially undermine *Central Bank* by rendering aider and abettor liability a nullity (and would also undermine the Court's *Stoneridge* decision on that score). With respect to the Government's argument that the Court should adopt the SEC's interpretation of "make"— i.e., that "make" is the same as "create," Thomas rejected that argument, writing that such wordsmithing "would permit private plaintiffs to sue a person who 'provides the false or misleading information that another person then puts into the statement'" (citing the Government's *amicus curiae* brief). Such a result, wrote Thomas, would be inconsistent with *Stoneridge*'s rejection of "scheme liability" and countless other Supreme Court precedents.[14]

On behalf of Justices Ginsburg, Sotomayor, and Kagan, Justice Stephen Breyer wrote a dissent, contending that "the majority has incorrectly interpreted [Rule 10b-5's] word 'make.'" After rejecting the direct applicability of *Central Bank* and *Stoneridge*, Breyer then opined that the corporate family structure of the various Janus entities was so closely interwoven (even if legally separate) that, based upon the allegations pleaded, it could be held that JCG "made" materially false statements in the prospectuses issued by JIF: "Unless we adopt a firm rule (as the majority has done here) that would arbitrarily exclude from the scope of the word 'make' those who manage a firm—even when those managers perpetrate a fraud through an unknowing intermediary—the management company at issue here falls within that scope."

Lorenzo (in the D.C. Circuit)

In October of 2009, Francis Lorenzo, the director of investment banking at a registered broker-dealer, sent allegedly false and misleading statements to two investors; the statements had originally been drafted by his boss (the head of the firm) and had been sent at his boss's behest. At the end of the emails containing the statements, Lorenzo block signed his name and urged the recipients to "call [him] with any questions."

In September of 2013, the SEC brought an enforcement proceeding against Lorenzo, his boss, and the broker-dealer; the latter two quickly settled with the Commission. Lorenzo decided to fight, and a SEC administrative law judge subsequently ruled that Lorenzo had "willfully violated the antifraud provisions" of the federal securities laws (Rules 10b-5(a), (b) & (c)).[15] She also opined that Lorenzo's "falsity" had been "staggering" and that his mental state had been at least "reckless." The full Commission, upon review of the ALJ's determinations, affirmed her decision, as well as her "imposition of an industry-wide bar, a cease-and-desist order, and a $15,000 civil penalty."[16] Lorenzo appealed that decision to the D.C. Circuit Court of Appeals.[17]

By a 2 to 1 vote, a D.C. Circuit panel (giving deference to the determinations of the Commission) found that Lorenzo's statements were false or misleading and that he acted with requisite scienter in sending them.[18] At the same time, however, the panel ruled that, under *Janus*, Lorenzo was not the "maker" of the statements, because they had been sent "on the behest of his boss" who had drafted and approved them (i.e., the boss had the "ultimate authority"). As a result, the panel found that Lorenzo had *not* violated Rule 10b-5(b).[19]

But the panel did not stop there. It also ruled that Lorenzo's conduct *did* violate the scheme liability provisions of 10b-5(a) and 10b-5(c).[20] Rejecting Lorenzo's argument that (at worst) what he had done was to aid-and-abet his boss's conduct, [21] the panel ruled that he was primarily liable under those other two anti-fraud provisions.[22]

The dissenting vote on the D.C. Circuit panel came from none other than then-Judge Brett Kavanaugh. And his dissent was a passionate one. First off, he noted that the factual record and the SEC ALJ's legal determinations did not "square up": "At most, the judge's factual findings may have shown some mild negligence on Lorenzo's part . . . . [I]t is impossible to find that Lorenzo acted 'willfully.'"[23] Kavanaugh then opined that the Commission had "simply swept the judge's factual and credibility findings under the rug" in its rush to judgment. In his view, the D.C. Circuit panel should not have given deference to the Commission, but should have instead looked *de novo* at the record developed before the ALJ to assess whether Lorenzo had *in fact* willfully engaged in a scheme to defraud.

Alternatively, Kavanaugh opined that the panel's decision "creates a circuit split by holding that mere misstatement, standing alone, may constitute the basis for so-called scheme liability under the securities laws." Citing contrary decisions directly on point by other circuits—that a scheme liability claim *must* be based upon conduct *beyond* misrepresentations or omissions to be actionable under Rule 10b-5(b),[24] Kavanaugh attributed his then-colleagues' decision to push the envelope as the result of the "SEC's attempts to unilaterally rewrite" the antifraud provisions of the securities laws—in the face of the Supreme Court's rulings which distinguished between primary and secondary liability: *Janus*, *Stoneridge*, and *Central Bank*.[25]

Oral Argument Before the Supremes

On June 18, 2018, the Supreme Court granted Lorenzo's cert petition. On December 3, 2018, the Court heard oral argument. In between those two dates, now-Justice Kavanaugh recused himself, so only eight Justices heard the argument and only they would decide the case.

Many speculated that the Court granted certiorari to once and for all resolve (for the fourth time) that primary liability for use of misleading statements *alone* is actionable only under Rule 10b-5(b) (and that it cannot be end-runned by the scheme liability provisions of Rules 10b-5(a) and 10b-5(c)). Such a result would be consistent with *Central Bank*, *Stoneridge*, *Janus*, case law following those decisions, and then-Judge Kavanaugh's dissent; it would also preserve the distinction between primary and secondary liability.[26]

But many observers of the *Lorenzo* oral argument seemed to believe that the Court's *Janus* divide of four to four might well be the outcome in Mr. Lorenzo's case, leaving the D.C. Circuit's decision in place. With such an outcome, we would have had a very strange state of affairs in the short to mid-term: for the time-being, there would be an expansive view of 10b-5 liability, allowing the SEC and private plaintiffs to bring primary liability fraud claims against secondary actor individuals (including lawyers) who did not "make" the alleged material misrepresentations; and then—presumably—when the next case reached the Court (with Justice Kavanaugh participating), liability exposure would be returned to the *Central Bank*, *Stoneridge*, *Janus* status quo.[27]

Were the speculators and observers correct? Unfortunately, no!

Lorenzo (in the Supreme Court)

Writing for a six Justice majority (Justices Roberts and Alito shifted from their *Janus* positions), Justice Breyer upheld the D.C. Circuit panel's decision. Unlike then-judge Kavanaugh, Justice Breyer started off his opinion by noting that "the relevant facts are not in dispute." He then observed that the panel's ruling on subsection (b) of Rule 10b-5 (*Lorenzo* was *not* a "maker" of the misrepresentations) was *not* a subject for the Supreme Court's review or re-visiting. Thus, the only issue before the Court was whether a non-"maker" could be subject to scheme liability under subsections (a) & (c) of Rule 10b-5. And Justice

Breyer, who had not participated in *Stoneridge*—but had made his views crystal clear in *Janus*, would re-write the Supreme Court's jurisprudence on that issue.[28]

Justice Breyer's first foray into this new jurisprudence emphasized the plain meaning of the words in subsections (a) & (c), and the fact that those words had to have substance beyond the words set forth in subsection (b).[29] Rejecting Lorenzo's argument (and a legion of decisions) that only a "maker" of misstatements could be accountable under subsections (a) & (c),[30] Justice Breyer opined that such a position "would render subsection b of Rule 10b-5 "superfluous" and (in his view) misunderstands the different and "considerable" overlapping ways the federal securities laws have been layered to capture as many fraudulent acts and actors as possible.[31]

As for the notion that allowing for actionable claims under subsections (a) & (c) would render *Janus* "a dead letter"—the dissent's view—Justice Breyer wrote: "we do not see how that is so." *Janus* only concerned the "maker" of the misrepresentation(s); there was nothing in *Janus* that addressed the "dissemination of false or misleading information." Thus, *Janus* would still preclude liability "where an individual neither *makes* nor *disseminates* false information." (emphasis in original)

As far as the majority undercutting the whole *raison d'etre* of *Central Bank*'s demarcation between primary and secondary liability (i.e., that, at best, Lorenzo aided and abetted the fraud; he was not a primary violator), Justice Breyer was unconcerned and waved off the notion that his opinion *greatly* expands potential liability for fraud.[32] He further justified this by citing to the investors who received Lorenzo's emails, and noting that those investors would "not view the deception" as less harmful coming from him, as opposed to coming from the actual "maker."

Finally, as for the undercutting/voiding the Court's *Stoneridge* decision, he first found that unavailing because the SEC, "unlike private parties, need not show reliance [by investors] in its enforcement actions."[33] But even more ominously (in the context of prospective private claims), Justice Breyer then wrote that "Lorenzo's conduct involved the direct transmission of false information intended to induce reliance [which] is far from the kind of concealed fraud at issue in *Stoneridge*." He concluded by rejecting (again) Lorenzo's *arguendo* argument that, at worst, he could only be held secondarily liable (based upon *Stoneridge*, *Central Bank*, et al.):

> That is not what Congress intended. Rather, Congress intended to root out all manner of fraud in the securities industry. And it gave to the Commission the tools to accomplish that job.[34]

Justice Clarence Thomas, the author of *Janus* (and on behalf of Justice Gorsuch), dissented. *Janus*, he declared, was now a "dead letter, " as were the Court's prior decisions in *Central Bank* and *Stoneridge*, and with them the "bright line" between primary and secondary violators, because "it is undisputed that Lorenzo did not engage in any conduct involving planning, scheming, designing, or strategizing," as required by subsection (a).[35] And subsection (c), which "seems broader at first blush," does not reach Lorenzo's conduct either (at least under the Court's prior jurisprudence). At bottom, and notwithstanding the majority's dicta suggestion that minor actors (e.g., mail clerks, secretaries) should not be caught up in the liability net,[36] Justice Thomas correctly noted that *any* person who "knowingly sen[ds] false statements" will now be exposed to primary violator liability.

Going Forward, Be Not a "Sender"

Previously, the key to avoiding fraud liability was to not be a "maker" of false statements. Obviously, that is no longer the case; it is evident, for example, that the conduct by the law firm in *Schatz v. Rosenberg* would be actionable under *Lorenzo*. [37]

More importantly, the SEC Enforcement Division has publicly promised to push the *Lorenzo* ruling beyond "dissemination," and has further predicted that the lower courts will be sympathetic to such an expansive reading.[38] Such a tack by the Commission (undoubtedly to be followed on closely by the private plaintiffs' bar) does not seem consistent with Justice Breyer's purported caution as to where the liability line will or should exist.[39] More importantly—at least to the readers of this august legal publication, think of what *Lorenzo* will likely mean to people who are tasked with preparing regulatory filings (i.e., lawyers) and/or those who play a role in communicating with the investing public. All of those folks now have a new reason to lose sleep and get gray hairs.[40]

Endnotes

1. Y. Berra, The Yogi Book ("I Really Didn't Say Everything I Said") 30 (1998) (Yogi's comment came after Mickey Mantle and Roger Maris hit back-to-back home runs for the umpteenth time.).
2. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994); *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148 (2008); *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011).
3. *See, e.g., Klein v. Boyd*, 1998 WL 55245, Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. 1998); *S.E.C. v. Wolfson*, 539 F.3d 1249 (10th Cir. 2008). The Zelig-like reemergence of this issue has been the subject of my pencil before. *See, e.g.*, C.E. Stewart, *While Rome Burns: Fiddling With Reforming Reform in the Securities Industry* (November 1998; National Legal Center for the Public Interest); C.E. Stewart, *Legal Ethics for Securities Lawyers: Traditional Norms Reinvigorated*, BNA Securities Regulation & Law Report 1409 (October 1, 2001); C.E. Stewart, *Liability for Securities Lawyers in the Post-Enron Era*, 35 The Review of Securities & Commodities Regulation 171 (September 11, 2002); C.E. Stewart, *Regulating the Legal Profession: Sense or Nonsense?* New York Law Journal (May 15, 2008).
4. No. 17-1077 (certiorari granted June 18, 2018; argued December 3, 2018); 139 S. Ct. 1094 (March 27, 2019).
5. 797 F.2d 490 (7th Cir. 1986).
6. 943 F.2d 485 (4th Cir. 1991).
7. *See Upjohn Co. v. U.S.*, 449 U.S. 383 (1981).

8. 511 U.S. 164 (1994).
9. 1998 WL 55245, Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. 1998).
10. *See, e.g., Howard v. Everex Systems Inc.*, 228 F.3d 1057 (9th Cir. 2000); *Ziemba v.Cascade International Inc.,* 2001 U.S. App. LEXIS 15529 (11th Cir. 2001); *In re* Enron Corp. Derivative & ERISA Litig., 236 F. Supp. 2d 161 (D. Mass. 2003); *Simpson v. AOL Time Warner Inc*., 452 F.2d 1040 (9th Cir. 2006). Of particular note is/was *SEC v. Wolfson*, 539 F.2d 1249 (10th Cir. 2008), where the Tenth Circuit upheld the SEC itself going after a non-employee consultant as a primary violator. That court noted that, unlike in a private cause of action, the SEC is under no burden of proving reliance or damages. *Id.* at 1258 n.14. *Accord SEC v. Goble*, 682 F.3d 934 (11th Cir. 2012).
11. 552 U.S. 148 (2008).
12. *See Basic v. Levinson*, 485 U.S. 224, 243 (1998). This brought on a hue and cry from the three dissenters, who claimed that the ruling was part of "the Court's continuing campaign to render the private cause of action under § 10(b) toothless." Those dissenters would have their revenge in 2019!
13. 564 U.S. 135 (2011).
14. *Id.* at n. 8. The SEC's expansive view of "make" had previously been rejected by other, lower courts. *See, e.g., SEC v. Tambone*, 597 F.3d 436 (1st Cir. 2010) (en banc).
15. Rule 10b-5 reads in its entirety:

    > It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. (Sec. 10; 48 Stat. 891; 15 U.S.C. 78j) [13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951]

16. The SEC also charged Lorenzo with violating § 17(a)(i) of the '34 Act, which essentially tracks subsection (a), making it unlawful to "employ any device, scheme, or artifice to defraud." SEC Release No. 74836, 111 SEC Docket 1761, 2015 WL 1927763, at *11 (April 29, 2015).
17. For some reason *Lorenzo* only challenged the industry bar and the monetary fine, not the cease-and-desist order.
18. *Lorenzo v. SEC*, 872 F.3d 578, 580 (D.C. Cir. 2017). On appeal to the Supreme Court, for some (unknown) reason Lorenzo did not challenge the panel's scienter finding.
19. Because of this ruling, the panel vacated the sanctions imposed by the Commission and remanded that issue for further consideration.
20. *Id.* at 589-90. *See supra* note 15.
21. The SEC did not charge Lorenzo with aiding and abetting, which the Central Bank Court ruled was still a valid claim for an enforcement proceeding. *See supra* note 8 and accompanying text.
22. The panel further opined that Sections 10(b) and 17(a)(i) of the '34 Act also "may encompass certain conduct involving the dissemination of false statements even if the same conduct lies beyond the reach of Rule 10b-5(b)." *Id*. at 592. *See supra* note 15.
23. Thus, according to Kavanugh the ALJ's decision violated "basic due process . . . [because] mens rea is essential to preserving individual liability," citing, *inter alia, Morissette v. United States*, 342 U.S. 246, 250-51, 263 (1952) (Justice Jackson).
24. *See Public Pension Fund Group v. KV Pharmaceutical Co.*, 679 F.3d 972, 987 (8th blob:https://teams.microsoft.com/5edaafd3-691e-41c2-8be8-8c21f936db7a Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc*., 655 F.3d 1039, 1057 (9th Cir. 2011); *Lantell v. Merrill Lynch &* Co., 396 F.3d 161, 177 (2d Cir. 2008). *Accord SEC v. Rio Tinto PLC*, 2019 U.S. Dist. LEXIS 43986, *51-52 (S.D.N.Y. March 18, 2019); *Alpha Capital Anstalt v. Schwell Wimpfheimer & Assocs*., 2018 U.S. Dist. LEXIS 54594, *34 (S.D.N.Y. March 30, 2018); *SEC v. Wey*, 246 F. Supp. 3d 894, 917-18 (S.D.N.Y. 2017); *SEC v. China Northeast Petroleum Holdings Ltd.*, 27 F. Supp. 3d 379, 391-92 (S.D.N.Y. 2014); *In re Smith Barney Transfer Agent Litig*., 884 F. Supp. 2d 152, 161 (S.D.N.Y. 2012).
25. 872 F.3d at 601. He cited one specific example of the SEC's attempts to "circumvent" these Supreme Court decisions: In the Matter of the John P. Flannery & James D. Hopkins, Release No. 3981 (December 15, 2017).
26. *See supra* note 24. It is important to remember that such a result would not have affected the SEC's ability to initiate aiding-and-abetting cases against secondary actors, nor would it have impacted the Commission's power to use Section 17 of the '33 Act to proceed against those who offer or sell securities "by means of any untrue statement of a material fact." *See, e.g., In re* The Reserve Fund Securities and Derivative Litigation, 2012 WL 12356742, at *9 (S.D.N.Y. October 8, 2012); *SEC v. Tambone,* 550 F.3d 106, 127-28 (1st Cir. 2008) and 597 F.3d 436, 450 (1st Cir. 2010).
27. *See* C.E. Stewart, *Fourth Time a Charm? The Supreme Court Takes Another Whack at Secondary Liability.* New York Law Journal (Dec. 27, 2018).
28. *See supra* note 12.
29. The same plain meaning analysis thus also applied to § 17(a)(1) of the '33 Act. *See supra* note 15.
30. This point had been the basis for rejecting liability in countless prior decisions. *See supra* note 24.
31. For this proposition, Justice Breyer cited, i*nter alia, United States v. Naftalin,* 441 U.S. 768, 77 (1979); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S, 128, 152-53 (1972*); SEC v. N.J. Howey Co., In re R.D. Boyle & Co*., 19 S.E.C. 73 (1945); *In re Arthur Hayes & Co*., S.E.C. 271 (1939).
32. Justice Breyer did seem to acknowledge that his opinion would expand fraud liability to "capture a wide[r] range of conduct." And that "[a]pplying [this new standard] may present difficult problems of scope in borderline cases." He then postulated, however, that "[p]urpose, precedent, and circumstances could lead to narrowing their reach in other contexts." Just what that means, or how it will play out, is quite unclear. But *see infra* note 38.
33. *See supra* note 10.
34. Justice Breyer cited no authority for this sweeping pronouncement. That is not surprising given that the Court had explicitly acknowledged the contrary in its prior decisions. *See supra* note 12 and accompanying text. Justice Breyer's imaginative interpretation of congressional intent would appear to be consistent with his theory of "delegated democracy," whereby he believes the Court should review and interpret legislation based upon what it believes a "reasonable member of Congress" must have meant when she passed a bill. *See* S. Breyer, Active Liberty, pp. 85-101 (Knopff 2005).
35. And § 17(a)(i) of the '34 Act.
36. *See supra* note 32.
37. *See supra note 6* and accompanying text.
38. *See* Securities Law360 (April 13, 2019). Indeed, in the first case "interpreting" *Lorenzo*, the SEC got the 10th Circuit to expand Lorenzo's scheme liability under Rule 10b-5(a) and (c), where the court found an individual liable for failing to correct another person's misstatement. *See Malouf v. SEC*, 933 F.3d 1248 (10th Cir. 2019).
39. *See supra* notes 32, 36 and 38 and accompanying text.
40. *See* G. Ballard & L. von Rigal, *Think Twice Before You Forward That Email!* New York Law Journal (July 15, 2019). Thus, as Bette Davis once famously emoted: "Fasten your seatbelts, it's going to be a bumpy [ride]!" *All About Eve* (20th Century Fox, 1950) (written and directed by Joseph L. Mankiewicz; produced by Darryl F. Zanuck).

Practical Tips for Drafting Agreements From "Whole Cloth"

By Joseph V. Cuomo and Keith Belfield

One of the biggest challenges faced by any contract lawyer is when a client or partner asks for an agreement to be prepared, and there is no clear precedent or starting point—the dreaded assignment of having to draft from "whole cloth." Without fail, this tall order is usually accompanied by a request that the draft is needed "yesterday."

This article will provide some helpful tips and strategies to navigate this challenge when it appears on your desk.

The Challenge

One of the mantras of any good contract lawyer is, "Don't reinvent the wheel." One of our mentors used to say "creativity is good . . . but copying is better." These guiding principles will typically apply to most contract drafting assignments. The usual approach is to find a prior agreement or form that is pretty close to what your client needs and customize it for the matter at hand. This is essentially the practice of most corporate attorneys.

However, from time to time, you may be tasked with preparing an agreement that raises your eyebrow a bit. *Gee, I don't think I've seen that one before.* You scan your brain's database for all of the agreements you have worked on in your career and find nothing. Next, you look to all of the precedent and form resources you frequently use, and again, nothing comes close. It may be that this client is engaged in a new cutting-edge business, or is engaged in an established business but in a new way. In any event, the client needs a draft, and you need to get cracking.

Step 1: Where to Start? Get the Client's "Vision"

Undoubtedly your client will have some sense as to what is needed, and likely some knowledge of the basic business terms. Your client's take on the underlying business terms is probably the best place to start. We will often ask the client to send over an email in whatever form that is easiest laying out the client's understanding of the agreement, the goals to be achieved, and the risks and issues to protect against. We do not ask for or expect good drafting by the client—just an expression of ideas in a businessman's hand. What we are looking for is a term sheet of sorts—a big-picture summary to help us see and understand the client's goals.

If appropriate, we may also ask the client if he or she has come across any sample agreements that have made an impression or might be relevant and if we can get a list of some competitors or similar parties in the industry that might be engaging in similar transactions. These inquiries may result, at best, in a serviceable sample or, at worst, a deeper understanding of the background surrounding the transaction and agreement. Taking these steps will assist you in developing a clear understanding of the client's vision so that you can draft an agreement that appropriately sets forth the client's rights and obligations.

Step 2: Finding Your Lump of Clay

As with any contract drafting assignment, you need some document to start with as it rarely makes sense to draft an agreement free form from scratch. Perhaps in Step 1, your client has provided you with a sample or identified a competitor that makes its agreements available online. Reviewing a sample agreement from your client or a competitor can be a good starting point, but you typically cannot just stop there.

It is essential to access as many resources as may be reasonably available to you so you can start to generate a pile of relevant sample agreements. Sources can include the most obvious—your files and prior agreement databases, in addition to those of your firm and colleagues. However, you are drafting something that has never been drafted before, so if it were that easy, there would be no need for this article. This exercise of accessing and stockpiling multiple resources will provide you with the building blocks you will need to move forward.

Additionally, when searching, you should keep in mind that if your current task involves a specific type of industry, you should look for agreements in that area. For example, if your client is primarily in the services industry, you should try to generate some good samples of services type agreements such as consulting agreements. This collection will help you see the structure and section headings you will need, including much of the boilerplate you will want to have in the back end.

Other resources include "old school" treatises and form books, many of which now have online counterparts and/or accompanying disks from which sample agreements can be copied. LexisNexis and Westlaw, depend-

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ing on the level of subscription, have extensive form agreement libraries that can be searched and accessed. Unlike precedent agreements from real-life deals, form agreements have not been negotiated or customized and generally contain relatively neutral but comprehensive provisions. Forms are also a great way to double-check that you have not missed anything. Additionally, forms can assist you if you need a relatively standard clause for something not covered in your base document.

Not surprisingly, the internet, in general, is a virtual treasure trove. Spending a little time doing general searches on the type of agreement you are working on often yields useful material. However, this is where your experience and judgment need to kick in. Some of the golden nuggets that you may mine may turn out to be fool's gold. Anything you find at this stage, including samples that are not from your database or a trusted colleague, or that did not pass the scrutiny of some form book editor, need to be reviewed carefully and cautiously. A useful resource for this stage is www.onecle.com, which aggregates and organizes agreements required to be filed by public companies by SEC requirements.

Step 3: Molding and Polishing the Draft

Once you have a pile of potentially useful samples and models, you should spend some time trying to identify the best example to start with. This step is time well spent because if you have a good starting point, the task at hand becomes much easier to execute efficiently. At this stage, you should also put aside three or four other samples to use for comparison purposes and/or to lift certain provisions. These comparables also serve as a useful check to make sure nothing was missed either in concept or actual language.

Now, it's time to put your drafting and organizational skills to the test by embodying your client's concepts and notes into your starting point base agreement, and improving the base agreement by lifting relevant provisions from your samples stockpile. When you begin drafting, it is imperative to think of the contract as a map guiding the parties through different factual situations, so that the parties will know their contractual duties over the life of the agreement. Throughout the drafting process you should constantly ask yourself what are the parties' duties, what is the timeline for performance, how will these duties be executed, and what should happen if one or both parties breach?

Once you have your first draft completed, it is essential that you read and re-read the agreement to ensure consistency, especially if your draft has drawn content from multiple sources. Look for consistency in the use of definitions, consistency in the parties' names and roles, consistency in the look and feel, and consistency in the contract structure, sections and sub-sections.

> "Reviewing a sample agreement from your client or a competitor can be a good starting point, but you typically cannot just stop there."

Finally, you should give the draft one last read to ensure that you completely understand the meaning and implications of every provision. If the agreement does not read cleanly and clearly to you, you can only imagine how the parties will view it.

Conclusion

Drafting an agreement from "whole cloth" is no doubt a challenging process, but with the proper approach and understanding, this tall order can be accomplished successfully. When this kind of assignment lands on your desk, you should not begin to panic. Instead, take a step back and follow some of the steps and suggestions discussed in this article. These tips and strategies will help you navigate the challenges of drafting an agreement from "whole cloth."

"Is This the Right Time To Sell My Business?"

By Stuart B. Newman

For many years this was a rhetorical question business owners usually asked their lawyers and advisors only when they began contemplating their own retirement. In today's more complex business environment, however, the question of when is the "right" time to sell a business may be ripe for discussion much sooner, because it now has strategic implications far more involved than a simple desire to take your chips off the table and spend more time with your family.

The emergence of the private equity market over the last decade or so has opened new opportunities for the founders of businesses—both large and small—to achieve personal goals far sooner than at their normal retirement age. There is a vast amount of money now chasing the right investment opportunity, with private equity funds willing to pay higher multiples than ever in the history of merger and acquisition transactions.

Moreover, from the perspective of the business founder, this current environment provides strategic opportunities beyond merely cashing-in and bringing a measure of personal financial security to him and his family. Since most private equity transactions are structured so that the seller usually retains a significant equity interest in the business going forward, they permit the founder to continue to be involved, and participate in the creation of even greater value, with new partners capable of providing additional capital, technology and managerial skills needed to bring what had been the family business to a whole new level.

Deciding whether this is the right time to sell your business now involves far more thought and advice than a personal assessment of whether this just feels like the right time to retire and head for the beach.

My business provides me with a nice profit every year, why should I sell it now?

A very common question. If the goose is giving you a steady stream of golden eggs, why sell the goose? This is certainly a valid point when businesses are selling for multiples around 5X EBITDA (earnings before interest, taxes, depreciation and amortization). To use an example, suppose a wholly owned business has been generating an average annual EBITDA of $500,000 which the owner distributes to himself. If the owner is offered 5X EBITDA for the business, is it worth it for him to sell, collect $2.5 million now? He is trading present dollars for what he might expect to earn over the next five years. But by doing so, he will have given up the opportunity to continue earning from the business beyond that period.

The answer to that question requires analyzing a number of factors, such as his confidence that the business will *continue* to generate cash flow at the same level, or whether the difference in tax rates between ordinary income and capital gains is meaningful to him. As valuations improve and multiples being offered by buyers increase, the tradeoff of a future income stream for a one-time capital payment certainly tilts in favor of a sale.

> "The emergence of the private equity market over the last decade or so has opened new opportunities for the founders of businesses—both large and small—to achieve personal goals far sooner than at their normal retirement age. "

Global economic conditions, at least through the end of 2019, were highly favorable for sellers, allowing them to achieve offers at high multiples. Bain & Company's Global Private Equity Report for 2019 identified nearly 3,000 private equity transactions worldwide with an aggregate buyout value of almost $600 billion. And this represents less than 10% of the overall number of annual M&A transactions—around 40,000 globally.[1]

What is clear is that it is a seller's market:

> After years of record-level fund-raising, PE [private equity] funds are awash in capital and face a growing need to put large amounts of money to work. Despite the strong pace of investment since 2014, PE dry powder, or uncalled capital, has been on the rise since 2012 and hit a record high of $2 trillion in December 2018 across all fund types.[2]

Not only is there a hunger for deals, private equity firms are willing to pay higher multiples to sellers: the

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Bain report observes that the M&A marketplace has seen an up-tick in valuations in recent years:

> In the years following the global financial crisis, regulators discouraged multiples of six times earnings before interest, taxes, depreciation and amortization (EBITDA). Yet in the Trump era's more relaxed regulatory environment, the share of deals with multiples of greater than seven times EBITDA rose to almost 40% of the total. . . .[3]

Even higher valuations are reported by other observers:

> Multiples are still on the rise growing from 9.6 times in 2015 to 10.4 in 2017 and 11.1 in 2018, inching closer to the 2007 peak of 11.3.[4]

It certainly becomes more interesting when a business owner has the opportunity to trade his current annual earnings from the business for double digit multiples.

Let's be clear, however: the EBITDA multiple a particular buyer will offer to buy a business from a particular seller will depend on a number of valuation factors, so that at any given time, there will be a range of multiples in the M&A marketplace. Only a handful of businesses sold will achieve the highest end of the range, but the multiples today are clearly higher than in the past.

To be sure, private equity is not the only game in town. We are in an era of globalization and consolidation. Large strategic buyers have an eye out for companies offering products and services that are compatible with, or line extensions for, their own businesses, and they are willing to pay handsomely to acquire them.

But money isn't everything.

True, indeed. Aside from the financial rewards available, there are other reasons why this may be a good time to sell your business.

Many successful businessmen have innate talents—creativity and vision; the ability to open doors for themselves and influence people; and perhaps most important, the stomach to take on risk and live with the consequences. Notwithstanding their natural talents, they may well lack a formal exposure and tutoring for the business skills needed to grow their company to the next level. Here's where a sale of their company to either a private equity or strategic buyer can provide something more than financial liquidity—an opportunity to experience and learn business skills on a level they have not yet been exposed to; skills that could be monetized while continuing to work for the buyer, or by moving on and developing a brand new business. I have seen this happen many times with clients who are born entrepreneurs, capable of successfully creating a series of businesses in their careers.

By selling a business, sellers could achieve financial security for themselves and their families, liquidity for new ventures, and possibly invaluable exposure to new skills and business concepts with which to start over again and create even greater success.

Endnotes

1. Bain & Company, Global Private Equity Report 2019, p. 3.
2. *Id.*, p. 7.
3. *Id.*, p.8.
4. McKinsey & Company, Global Private Market Review 2019, p. 22.

The CCPA Is Here: What Financial Institutions Need To Know About the California Consumer Privacy Act

By David J. Oberly and Tanweer Ansari

As of January 1, 2020, the California Consumer Privacy Act of 2018 (CCPA) is now the law of the land, having gone into effect at the beginning of this year. One of the more complex issues concerning the CCPA pertains to the extent to which financial institutions governed by the Gramm-Leach-Bliley Act (GLBA) must adhere to the mandates of the CCPA. While California's new privacy law does afford a carve-out for financial institutions, it does not provide a comprehensive, across-the-board "get out of jail free" card for the financial services industry. Consequently, at this juncture it is imperative that all covered financial institutions ensure that they are in compliance with the CCPA to minimize the potential liability risk that now exists for noncompliance with the law. Fortunately, through the implementation of several best practices, financial institutions can continue to effectively leverage data in the course of their business operations, while at the same time steering clear of the potential pitfalls that could result in substantial liability exposure resulting from a failure to adhere to the CCPA's broad mandates.

The CCPA's GLBA Carve-Out

The CCPA was amended in September 2018, and now provides the following carve-out for financial institutions: "This title shall not apply to personal information collected, processed, sold, or disclosed pursuant to the federal Gramm-Leach-Bliley Act (Public Law 106-102), and implementing regulations, or the California Financial Information Privacy Act . . . . This subdivision does not apply to Section 1798.150." Pursuant to this language, the financial institution carve-out applies to personal information that is collected "pursuant to" the GBLA or the California Financial Information Privacy Act ("CFIPA"). Thus, financial entities will be subject to the requirements of the CCPA where they engage in activities that fall outside the scope of the GLBA.

Specifically, the GLBA applies to financial institutions' collection and use of "nonpublic personal information," which is defined as personally identifiable financial information provided by a consumer to a financial institution that results from a consumer transaction or that is otherwise obtained by the financial institution. While this definition seems expansive at first glance, the Federal Trade Commission (FTC) has issued guidance specifying that the term applies only to information that is collected about an individual in connection with providing a financial product or service. Conversely, the CCPA provides for a much broader definition of "personal information" that extends to include all information "that identifies, relates to, describes, is capable of being associated with, or could reasonably be linked, directly or indirectly, with a particular consumer or device."

As such, while financial institutions are generally exempted from complying with the CCPA in connection with personal information collected through core consumer financial activities, the carve-out does not provide a blanket exemption, and there will be certain scenarios where banks will be required to comply with California's new privacy law. Specifically, if a financial institution collects personal information outside the context of providing a financial service or product, the institution will be subject to the mandates of the CCPA.

In addition, the financial institution carve-out also expressly provides that the exemption does not apply to CCPA § 1798.150. That provision sets forth a private right of action for consumers to pursue individual or class litigation, with significant allowable statutory damages, where the consumer's personal information has been impacted by a data breach and the institution is found to have violated its duty to implement "reasonable" data security measures. As such, GLBA-regulated entities are now subject to being on the receiving end of consumer-initiated CCPA lawsuits in the event the institution suffers a data breach.

Compliance Strategies for Financial Institutions

Importantly, as the CCPA does not provide a comprehensive exemption for the financial services industry, financial institutions must ensure that they have satisfied their current compliance obligations placed on them under California's new, sweeping privacy law. So what must covered financial institutions do in order to ensure they are compliant with the CCPA?

In terms of actionable compliance steps themselves, the first order of business to get in compliance with the CCPA is to conduct a data mapping and inventory exer-

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cise to determine what personal information is not exempted by the GLBA carve-out and, in turn, is "in scope" for purposes of the CCPA. In addition, from a broader perspective, data mapping is also a prudent course of action for financial institutions to take in order to prepare for the additional regulatory changes that are sure to come in the immediate future.

To accomplish this task, institutions must map and inventory every piece of personal information that is collected, used, and sold by the institution, as well as all of the institution's data processing practices. In doing so, institutions will need to analyze all aspects of their organization, and all points where the institution collects, utilizes, or transmits information for any purpose and in any format. From there, institutions should determine—dataset by dataset—whether the entity's personal information is covered by the GLBA or the CFIPA, which would remove it from the scope of the CCPA. When performing this task, financial institutions should keep in mind that application of the CCPA will depend on the context in which personal information is collected, used, and shared and, as such, some of the same data elements—including names, IP addresses, and email addresses—may be excluded from the scope of the CCPA in some scenarios, but not in others.

Second, financial institutions must maintain systems and procedures to ensure adherence to the myriad of broad consumer rights that have been afforded to consumers under California's new privacy law, including the following: (1) right to know; (2) right to access; (3) right to opt-out; (4) right to deletion; and (5) right to equal service and pricing. In particular, institutions must maintain the operational capabilities to provide information to consumers upon request in the event a consumer seeks information regarding the data that is collected and sold by the institution, including the specific pieces of information that the institution has collected concerning the requesting consumer.

Third, institutions must also provide the mandated privacy disclosures and notices that are required by the CCPA. Here, institutions must include in their privacy policies the information that is required to be affirmatively disclosed to consumers pertaining to the institution's data practices and consumers' rights under the CCPA, including a toll-free number and a website for consumers to submit requests, as well as a link on the institution's web page entitled "Do Not Sell My Personal Information" to facilitate the opt-out process.

Fourth, as the financial institution carve-out does not apply to the CCPA's "reasonable" security requirement and private right of action provision, financial institutions also must have in place the necessary data security measures and controls that are required to comply with the CCPA. While the CCPA does not impose any express, direct data security requirements on financial institutions, the CCPA does require that institutions put in place "reasonable security procedures and practices" to protect personal information from being improperly accessed, disclosed, or acquired.

Financial institutions must ensure that they are in strict compliance with this obligation, as consumers are entitled to pursue litigation under the CCPA's private right of action provision if their data is impacted by a data breach event and the institution is found to have violated its duty to implement reasonable security measures. Consumers can pursue individual or class lawsuits if their data is compromised by a data breach, and can recover between $100 and $750 in statutory damages per incident. Although this damages figure may seem small, institutions must keep in mind that a class of just 10,000 consumers under the CCPA would subject an institution to $7.5 million in potential exposure.

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To further complicate matters, although financial institutions are subject to liability under the CCPA for data breaches arising out of violations of the duty to implement reasonable security measures, the CCPA does not provide any description of this duty nor offer any insight as to what satisfies the threshold for maintaining "reasonable" security measures.

In the absence of any formal CCPA guidance, financial institutions can consider implementing the data security measures previously endorsed by the California attorney general in its 2016 Data Breach Report. In the Report, the California AG endorsed the Center for Internet Security's Critical Security Controls ("CIS Controls"), a set of 20 different data security safeguards that were viewed by the then-AG as constituting reasonable security measures. As such, these CIS Controls can be used as a guide for complying with the reasonable security requirement of California's new privacy law.

In addition, financial institutions should also consider supplementing the CIS Controls by incorporating other well-accepted information security frameworks into their security programs—such as the International Standard Organization's (ISO) 27001 Series and the National Institute of Standards and Technology's (NIST) Cybersecurity Framework—which can aid in further demonstrating an institution's satisfaction of the "reasonable" security requirement so as to avoid class action litigation under the CCPA's private right of action provision.

Finally, financial institutions should also ensure that their cyber coverage policies extend to cover the full range of CCPA-related liabilities. While privacy liability is ordinarily a staple in most cyber insurance policies, this coverage is oftentimes triggered only in the event of a data breach. Importantly, however, under the CCPA a wide range of privacy violations can still take place outside of the data breach context. As such, many financial institutions may find that their current cyber coverage does not adequately shield them against the CCPA's broad statutory liabilities. To avoid any gaps in coverage, financial institutions must ensure that their policies provide coverage for acts or omissions stemming from the collection, use, disclosure, and storage of "personal information," as that term is used in the CCPA. In addition, cyber policies should also afford coverage for legal fees associated with regulatory investigations, regulatory fines, data breach response costs, and liabilities stemming from class action litigation.

Conclusion

While the CCPA affords some level of relief to financial institutions from the onerous obligations placed on covered businesses under California's new privacy law, the CCPA does not provide financial institutions with a complete exemption from the law. Rather, entities governed by the GLBA are subject to the mandates of the CCPA if they collect, use, sell, or share the personal information of California consumers outside of the context of providing a consumer financial service or product.

As such, because the CCPA went into effect at the start of the year, financial institutions that fall under the scope of the CCPA should be in full compliance with the law at this time. For those institutions that have yet to finalize their CCPA compliance efforts, now is the time to take action to bring themselves in line with the CCPA's requirements, especially with the California attorney general having begun its enforcement efforts on July 1, 2020. At the same time, financial institutions should also remain on the lookout for the finalized version of the CCPA Regulations, which may impose additional compliance burdens that would require covered institutions to further tweak their privacy compliance programs to align themselves with any new wrinkles in the CCPA that may come about when the final Regulations are issued.

U.S. Agencies Proposed Revisions to Volcker Rule Covered Funds Provisions

By Carol Hitselberger, Thomas Delaney, and Jeffrey Taft

On January 30, 2020, the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the "Agencies") proposed revisions to the covered funds provisions of the Volcker Rule (the "Proposal").[1] The Proposal is intended to address the prohibitions and restrictions regarding covered fund activities in the same way that the Agencies' August 2019 rulemaking primarily focused on the Volcker Rule's restrictions on proprietary trading.[2]

The Agencies intend for the Proposal to clarify, streamline, and ease the compliance burden of the covered funds provisions of the Volcker Rule by:

- Codifying foreign excluded fund relief for non-U.S. banking entities;
- Incorporating some Section 23A exemptions into the "Super 23A" restrictions;
- Easing the compliance burden for loan securitizations, foreign public funds, and small business investment companies;
- Creating four new exclusions for banking entities to invest in or sponsor credit funds, venture capital funds, customer facilitation funds, and family wealth management vehicles;
- Narrowing the scope of the definition of ownership interest; and
- Clarifying the treatment of parallel direct investments by a banking entity in the same underlying investments as a sponsored covered fund.

While the proposed revisions address many of the implementation and compliance issues raised by the current regulation, the Proposal also requests comment on the proposed revisions, as well as other potential changes that the Agencies are considering. The comment period on the Proposal ended on April 1, 2020. We have summarized the proposed revisions below.

Exemptions for Foreign Excluded Funds

The Proposal would create new exemptions to the prohibitions against proprietary trading and covered fund activities (as opposed to exclusions) for qualifying foreign excluded funds. Currently, a non-U.S. fund that is offered and sold outside of the United States could be subject to the prohibitions against proprietary trading and engaging in covered fund activities as a result of being excluded from the definition of a covered fund. This situation would occur if a non-U.S. banking entity controlled the excluded fund (e.g., based on common corporate governance, such as where the fund's sponsor selects the majority of the fund's directors or trustees), with the result that the excluded fund would itself be considered a banking entity and therefore subject to the Volcker Rule's proprietary trading and covered fund restrictions.

The federal banking agencies had addressed this issue by announcing in a joint policy statement that they would not take enforcement action against a non-U.S. banking entity based on the activities and investments of its foreign excluded funds that met certain criteria, referred to as "qualifying foreign excluded funds."[3] The Proposal would codify this regulatory relief by creating exemptions for such funds using the same criteria as the policy statement. Specifically, the exemptions would be available to a banking entity (i.e., the foreign excluded fund) that:

- Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;
- Would be a covered fund if the entity were organized or established in the United States, or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments;
- Would not otherwise be a banking entity except by virtue of the acquisition or retention of an ownership interest in, sponsorship of, or relationship with the entity, by another banking entity that meets the following: (i) the banking entity is not organized, or directly or indirectly controlled by a banking entity that is organized, under the laws of the United States or of any State; and (ii) the banking entity's acquisition or retention of an ownership interest in or sponsorship of the fund meets the requirements

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for permitted covered fund activities and investments solely outside the United States, as provided;

- Is established and operated as part of a bona fide asset management business; and
- Is not operated in a manner that enables the foreign banking entity to evade the requirements of the Volcker Rule.

Modifications to Existing Exclusions

Loan Securitizations

The existing loan securitization exclusion (LSE) excludes certain loan securitization vehicles[4] from the definition of covered funds if they hold only loans and certain loan-related rights and assets. The Proposal would relax two key eligibility criteria to rely on the LSE. First, the Proposal would permit a qualifying loan securitization to hold non-loan assets (e.g., corporate bonds or derivatives) of no more than 5 percent of the securitization's total assets.[5] This partially responds to industry feedback that historically such vehicles incorporated "bond buckets" and other types of non-loan assets into the pool of securitized loan assets. Second, the Proposal would codify an FAQ issued by the staff of the Agencies in 2014, which indirectly addressed a typographical error in the regulation by stating that, while a servicing asset may or may not be a security, if the servicing asset is a security, it must be a permitted security under the exclusion.[6] The definition of "cash equivalents" in the FAQ relating to the definition of "permitted security" also would be codified by the Proposal.[7]

The Proposal does not explicitly clarify whether the LSE may be used to hold operating leases or lease residuals in a qualifying loan securitization. The preamble suggests that the Agencies believe that such a clarification is unnecessary because leases are already included in the definition of "loans" and thus are already permitted assets under the current exclusion, but does not explicitly address the distinction between capital and operating leases. Further, nothing in the Proposal would explicitly address the holding of underlying leased assets (including monetized residuals) in securitizations.

Foreign Public Funds

The Proposal would modify the current exclusion for foreign public funds by updating relevant definitions, requirements, and limitations. Currently, a "foreign public fund" is defined as any investment fund that is organized outside of the United States, the ownership interests of which are (1) authorized to be sold to retail investors in the fund's home jurisdiction and (2) sold predominantly through one or more public offerings outside of the United States. The Proposal would replace these requirements with a single requirement that ownership interests in the putative covered fund are offered and sold through at least one public offering outside of the United States.

> "The Proposal is intended to address the prohibitions and restrictions regarding covered fund activities in the same way that the Agencies' August 2019 rulemaking primarily focused on the Volcker Rule's restrictions on proprietary trading. "

To help ensure that funds qualifying for the exclusion are sufficiently similar to U.S. registered investment companies, the Proposal would modify the definition of "public offering" to add a new requirement that the distribution be subject to substantive disclosure and retail investor protection laws or regulations in the jurisdiction where it is made. Additionally, the Proposal would limit the requirement that distributions comply with all applicable requirements in the jurisdiction where it is made to only apply to instances when a banking entity acts as the investment manager, investment adviser, commodity trading advisor, commodity pool operator, or sponsor of the fund, addressing potential difficulties faced by a banking entity investing in a fund sponsored by a third party.

The proposed revisions also would eliminate the limitation on selling ownership interests of the foreign public fund to employees (other than senior executive officers) of the sponsoring banking entity or fund (or affiliates of the banking entity or fund). The limits on the sale of ownership interests to directors or senior executive officers of the sponsoring banking entity or the fund (or their affiliates) would remain in place.

Public Welfare Funds and Small Business Investment Companies

Public Welfare Funds

The Proposal requests information on whether any changes should be made to clarify that all excluded public welfare investment funds, under any agency's regulation, are excluded from the covered funds restrictions of the Volcker Rule. In particular, the Proposal poses several questions related to the interactions and potential incongruences between qualifications for the public welfare exclusion and the Community Reinvestment Act (CRA). For example, the Agencies asked if they should "establish a separate exclusion for CRA-qualified investments or incorporate such an exclusion into the exclusion for public welfare investments."

Some of the federal banking agencies are currently considering revisions to CRA regulations. The FDIC and OCC recently issued a proposed rulemaking that, if adopted, would extensively update the agencies' respective CRA regulations.[8] Given the Proposal's apparent focus on harmonizing the public welfare exclusion with the CRA, any revisions to the latter will likely have a material impact on the exclusion.

Small Business Investment Companies

The Proposal would revise the small business investment companies (SBICs) exclusion to clarify how the exclusion would apply to SBICs that surrender their license during wind-down phases. The revision would specify that the exclusion for SBICs applies to an issuer that was an SBIC that has voluntarily surrendered its license to operate as a small business investment company in accordance with 13 C.F.R. § 107.1900 and does not make new investments (other than investments in cash equivalents) after such voluntary surrender. The expanded exclusion, however, would not be available for an SBIC that has had its license revoked.

Rural business investment companies (RBICs) and qualified opportunities funds (established under the "opportunity zone" program from the Tax Cuts and Jobs Act) (QOFs) were not mentioned in the proposed revisions but did receive attention from the Agencies in their request for comments. Specifically, question 21 asks for information on the status of RBICs under the current exclusions and the potential merits of creating an explicit exclusion for RBICs, and question 22 poses similar questions regarding QOFs.

New Covered Fund Exclusions

Credit Funds

The Proposal would create a new exclusion for credit funds that make loans, invest in debt, or otherwise extend the type of credit that banking entities may provide directly under applicable banking law. A "credit fund" would be defined as an issuer whose assets consist solely of: (i) loans; (ii) debt instruments; (iii) related rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans, or debt instruments; (iv) certain interest rate or foreign exchange derivatives.

The exclusion would be subject to certain limitations and conditions. Under the Proposal, a credit fund could not (i) engage in activities that would constitute proprietary trading, as defined in Section __.3(b)(1)(i) of the Volcker Rule[9] (as if the fund were a banking entity); or (ii) issue asset-backed securities.[10] Additionally, the availability of the credit fund exclusion would be subject to compliance with the following conditions:

- If a banking entity sponsored or served as an investment adviser or commodity trading advisor to a credit fund, the banking entity would be required to provide disclosures specified in Section __.11(a)(8) to any prospective and actual investor (e.g., that losses will be borne solely by investors and not the banking entity and that the ownership interests in the fund are not insured by the FDIC and are not deposits, obligations of, or endorsed or guaranteed by the banking entity, among others) and ensure that the activities of the credit fund are consistent with safety and soundness standards[11] that are substantially similar to those that would apply if the banking entity engaged in the activities directly;
- A banking entity would not be permitted to rely on the credit fund exclusion if (i) it guarantees, assumes, or otherwise insures the obligations or performance of the fund, or (ii) the fund holds any debt securities, equity, or rights to receive equity that the banking entity would not be permitted to acquire and hold directly;
- A banking entity's investment in and relationship with a credit fund would be required to comply with the "Super 23A" restrictions in Section __.14 (except the banking entity would be permitted to acquire and retain any ownership interest in the credit fund), and the prudential limitations in Section __.15 regarding material conflicts of interest, high-risk investments, and safety and soundness and financial stability, in each case as though the credit fund were a covered fund;
- A banking entity's investment in, and relationship with, a credit fund also would be required to comply with applicable safety and soundness standards; and
- A banking entity that invests in or has a relationship with a credit fund would continue to be subject to capital charges and other requirements under applicable banking law.[12]

Venture Capital Funds

The Proposal would create a new exclusion for qualifying "venture capital funds," which it defines as an issuer that meets the definition in Rule 203(1)-1 under the Investment Advisors Act of 1940 and that does not engage in any activity that would constitute proprietary trading (as defined in Section __.3(b)(1)(i) of the Volcker Rule), as if it were a banking entity. In order to rely on the exclusion, any banking entity that acts as a sponsor, investment adviser, or commodity trading adviser to the venture capital fund would be required to provide in writing to any prospective and actual investor the disclosures required under Section __.11(a)(8), as if the venture capital fund were a covered fund, and ensure that the activities of the fund are consistent with safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly.

The proposed exclusion would also require a banking entity's ownership interest in or relationship with a qualifying venture capital fund to comply with the restrictions imposed by Super 23A (discussed below) (except the banking entity could acquire and retain any ownership interest in the fund) and by the prudential backstops, as if the venture capital fund were a covered fund and to be conducted in compliance with, and subject to, applicable banking laws and regulations, including applicable safety and soundness standards. A banking entity that relies on the exclusion would not, directly or indirectly, be permitted to guarantee, assume, or otherwise insure the obligations or performance of the venture capital fund.

The Agencies indicated they are considering an additional restriction on the exclusion to limit it to funds that do not invest in companies that, at the time of the investment, have more than a limited dollar amount of total annual revenue, calculated as of the last day of the calendar year (e.g., $50 million). The Agencies are considering what specific threshold would be appropriate and requested comments on the issue, among others.

Family Wealth Management Vehicles

The Proposal would create a new exclusion for family wealth management vehicles. Under the proposed exclusion, a "family wealth management vehicle" would include any entity that is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, provided that (i) if the entity is a trust, the grantor(s) of the entity are all family customers[13] and, (ii) if the entity is not a trust, a majority of the voting interests are owned (directly or indirectly) by family customers and the entity is owned only by family customers and up to three closely related persons[14] of the family customers.

Under the Proposal, this exclusion would be available to a banking entity only if it (or an affiliate):

1. Provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the family wealth management vehicle;
2. Does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such family wealth management vehicle;
3. Complies with the disclosure obligations under Section __.11(a)(8), as if the family wealth management vehicle were a covered fund;
4. Does not acquire or retain, as principal, an ownership interest in the entity, other than up to 0.5 percent of the entity's outstanding ownership interests that may be held by the banking entity and its affiliates for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns;
5. Complies with the Super 23A restrictions and prudential backstops (i.e., Sections __.14(b) and __.15) as if the family wealth management vehicle were a covered fund; and
6. Complies with the low-quality assets prohibition of Regulation W (12 C.F.R. § 223.15(a)), as if such banking entity and its affiliates were a member bank and the family wealth management vehicle were an affiliate thereof.

Customer Facilitation Vehicles

The Proposal would create a new exclusion for customer facilitation vehicles. The proposed exclusion would be available for any issuer that is formed by or at the request of a customer of the banking entity for the purpose of providing such customer (which may include one or more affiliates of such customer) with exposure to a transaction, investment strategy, or other service provided by the banking entity. The condition that vehicles be formed by or at the request of a customer would not preclude a banking entity from marketing its services through the use of customer facilitation vehicles or discussing with its customers prior to formation of the customer facilitation vehicle the potential benefits of structuring such services through a vehicle.

Additionally, a banking entity would be required to satisfy the following conditions to rely on the exclusion for customer facilitation vehicles:

1. All of the ownership interests of the customer facilitation vehicle are owned by the customer (which may include one or more of its affiliates) for whom the vehicle was created, subject to paragraph 2.d. below; and
2. The banking entity and its affiliates:
   a. Maintain documentation outlining how the banking entity intends to facilitate the customer's exposure to such transaction, investment strategy, or service;
   b. Do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the customer facilitation vehicle;
   c. Comply with the disclosure obligations under Section __.11(a)(8), as if the customer facilitation vehicle were a covered fund;

d. Do not acquire or retain, as principal, an ownership interest in the customer facilitation vehicle, other than up to 0.5 percent of the vehicle's outstanding ownership interests that may be held by the banking entity and its affiliates for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns;

e. Comply with the Super 23A restrictions and prudential backstops (i.e., Section __.14(b) and __.15) as if the customer facilitation vehicle were a covered fund; and

f. Comply with the low-quality assets prohibition of Regulation W (12 C.F.R. § 223.15(a)), as if such banking entity and its affiliates were a member bank and the customer facilitation vehicle were an affiliate thereof.

Exemptions from Super 23A Restrictions

The Volcker Rule generally prohibits a banking entity from entering into a transaction with a covered fund that would be a covered transaction as defined in Section 23A of the Federal Reserve Act (e.g., a loan or extension of credit to an affiliate, or a purchase of or an investment in securities issued by an affiliate). Section 23A of the Federal Reserve Act, as implemented by the Board in Regulation W, includes a number of exemptions from its restrictions that are not currently incorporated by the Volcker Rule. This results in the restrictions under the Volcker Rule (referred to as "Super 23A" because it applies the Section 23A restrictions to a broad set of transactions by nonbank affiliates) applying to a much larger universe of relationships.

Exempt Transactions under Section 23A and the Board's Regulation W

The Proposal would permit a banking entity to engage in covered transactions with a related covered fund that would be exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition under Section 23A of the Federal Reserve Act, including transactions that would be exempt pursuant to 12 C.F.R. § 223.42. Such exempt transactions include making correspondent banking deposits, giving credit for uncollected items, and transactions secured by cash or US government securities, among others.

Short-term Extensions of Credit and Acquisitions of Assets in Connection with Payment, Clearing, and Settlement Services

The Proposal would permit a banking entity to provide short-term extensions of credit to and purchase assets from a related covered fund, subject to limitations. Such limitations would include:

- Each short-term extension of credit or purchase of assets would have to be made in the ordinary course of business in connection with payment transactions; securities, derivatives, or futures clearing; or settlement services.
- Each extension of credit would be required to be repaid, sold, or terminated no later than five business days after it was originated.
- Each short-term extension of credit must also meet the same requirements applicable to intraday extensions of credit under 12 C.F.R. § 223.42(l)(1)(i) and (ii) as if the extension of credit was an intraday extension of credit, regardless of the duration of the extension of credit.[15]

> "The Proposal would permit a banking entity to provide short-term extensions of credit to and purchase assets from a related covered fund, subject to limitations. "

Additionally, each extension of credit or purchase of assets permitted by these revisions would be required to comply with the prudential backstops.

Narrowing of Definition of Ownership Interest

The regulation defines an "ownership interest" in a covered fund as any equity, partnership or other similar interest. An "other similar interest" is defined by reference to a broad list of characteristics, which arguably include certain standard provisions in debt instruments (e.g., the right to vote on a nominated replacement manager upon an investment manager's resignation or removal). To address this issue, the Agencies proposed (i) clarifying amendments to the definition of "other similar interest" and (ii) creating an express safe harbor for senior loans and senior debt. The Agencies also propose amending the manner in which banking entities must calculate their ownership interests for purposes of complying with the limits for certain exempted covered fund activities.

Creditor Remedies

The Proposal would adjust a parenthetical in the definition of ownership interest to specify that creditors' remedies upon the occurrence of an event of default or an acceleration event include the right to participate in the removal of an investment manager for cause or to nominate or vote on a nominated replacement manager upon an investment manager's resignation or removal.

This proposed revision falls short of what the industry had sought in terms of this prong of the ownership interest definition as it does not expand the realm of creditor remedies that would be excluded from the definition. Rather, it would explicitly identify two types of remedies that are covered by the current exclusion.

Specifically, the modified parenthetical would state that the ownership interest definition "exclude[s] the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event, *which includes* the right to [i] participate in the removal of an investment manager for cause or to nominate or [ii] vote on a nominated replacement manager upon an investment manager's resignation or removal" (emphasis added). This modification would not expand the scope of what is currently excluded from the definition of ownership interest given that the exclusion of the specified remedies is conditioned upon the occurrence of an event of default or an acceleration event, and these remedies were already understood by the industry to fall within the exclusion if so conditioned.

The questions posed by the Agencies related to this adjustment suggest that a meaningful change to the definition is still possible for the final rule. Specifically, Question 78 of the Proposal asks whether the revision should be expanded to include the right to participate in any removal of an investment manager for cause, or to nominate or vote on a nominated replacement manager upon an investment manager's resignation or removal, whether or not an event of default or an acceleration event has occurred.

Safe Harbor

The Proposal would create a safe harbor from the definition of ownership interest. Specifically, any senior loan or other senior debt interest that meets all of the following characteristics would not be considered to be an ownership interest under the proposed rule:

- Under the terms of the interest, the holders of such interest do not receive any profits of the covered fund but may only receive: (i) interest payments which are not dependent on the performance of the covered fund; and (ii) fixed principal payments on or before a maturity date;
- The entitlement to payments under the terms of the interest is absolute and may not be reduced because of the losses arising from the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the principal and interest payable; and
- The holders of the interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).

The Agencies did not define "senior" in the Proposal, nor did they provide any guidance in the accompanying preamble on how to determine if a particular loan or other debt interest is "senior." Our initial view is that "senior" is not limited to "most senior" but rather includes those loans or other debt interests that are generally understood as senior in the market for the particular type of transaction. It is possible that certain rules of thumb will develop for identifying "senior" debt interests in the context of a given market. Depending on the context this could mean, for example, a senior loan benefiting from equity subordination, a debt instrument with an investment grade rating, a debt instrument with a 20 percent risk weighting under US regulatory capital rules, or something else entirely. These examples are not definitive or exhaustive, nor do we mean to suggest that a debt interest that falls outside any such rules of thumb will not be "senior"—rather, such an instrument will require an attribute-based analysis to determine it qualifies as "senior" in a given transaction.

Additionally, one of the Agencies' questions in this section also suggests potential ambiguity. Question 79 requests comments on whether the Agencies should modify the regulation "to clarify that only an interest which has the right to receive a share of the 'net' income, gains or profits of the covered fund is an ownership interest." The implication of this request may raise concerns relative to current industry practice and expectations.

Fund Investment Limits

The Proposal would modify the implementing regulations to better align the manner in which a banking entity calculates the aggregate fund limit and covered fund deduction with the manner in which it calculates the per fund limit, as it relates to investments by employees of the banking entity. Specifically, the Proposal would modify Sections __.12(c) and __.12(d) to require attribution of amounts paid by an employee or director to acquire a restricted profit interest only when the banking entity has financed the acquisition.

Parallel Direct Investments

The Proposal would clarify that a banking entity need not include investments made alongside a covered fund in its per-fund and aggregate funds ownership limitations calculations as long as certain conditions are met.

The clarification would be made in the form of a rule of construction which would provide that:

- A banking entity would not be required to include in the calculation of the investment limits under Section __.12(a)(2) any investment the banking entity makes alongside a covered fund as long as the investment was made in compliance with applicable laws and regulations, including applicable safety and soundness standards; and
- The amount of any investment the banking entity makes alongside a covered fund would not be restricted under Section __.12 as long as the investment was made in compliance with applicable laws and regulations, including applicable safety and soundness standards.

Conclusion

Overall, the Proposal represents a meaningful step toward rationalizing the Volcker Rule. The proposed revisions include several changes that were requested by the structured finance industry as well as some other changes that likely will be welcomed by the banking entities subject to the Volcker Rule. However, there remain several areas in which the Proposal can be further refined. We expect that industry comment letters will thoughtfully address these and other open items.

Endnotes

1. Agencies Propose Changes to Modify "Covered Funds" Restrictions of Volcker Rule (January 30, 2020), available at https://www.occ.gov/news-issuances/news-releases/2020/nr-ia-2020-11.html.
2. The 2019 revisions included incremental adjustments to limited aspects of the covered funds provisions, but deferred further action on other covered funds issues to a later rulemaking. See Mayer Brown's Legal Update on the 2019 Revisions: https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/08/volcker-rule-2019-revisions-new.pdf.
3. *See* Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 17, 2019), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190717a1.pdf; Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 21, 2017), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf.
4. A loan securitization vehicle that relies on the exemption provided for in Rule 3a-7 under the Investment Company Act of 1940 would not need to rely on the LSE because it is not a covered fund.
5. The Proposal does not address how off-balance sheet instruments (e.g., derivatives) would be valued under the 5% of total assets test.
6. The Loan Securitization Servicing FAQ (#4) is available at https://www.federalreserve.gov/supervisionreg/faq.htm.
7. The Loan Securitization Servicing FAQ defines "cash equivalents" as high quality, highly liquid investments whose maturity corresponds to the securitizations' expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities. The agencies are not requiring cash equivalents to be short term.
8. For additional information on the FDIC and OCC proposed rulemaking, see Mayer Brown's Legal Update on the issue: https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/01/betterforbanksproposedcommunityreinvestment.pdf.
9. Proprietary trading means engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments and includes purchasing or selling a financial instrument with a short-term trading intent. Section __.3(a)-(b).
10. The Proposal notes that the proposed exclusion for credit funds is similar to the current exclusion for loan securitizations (other than the fact that the LSE requires the issuance of asset-backed securities, and the credit fund exclusion would prohibit it). Question 38 of the Proposal requests comments on potentially combining the two exclusions.
11. The Proposal does not specify which safety and soundness standards the Agencies would consider applicable for the purposes of the credit fund exclusion. Question 33 of the Proposal suggests the Agencies are considering including references to banking agency safety and soundness regulations in the final rule and requests comments on what, if any, standards should be referenced in the exclusion.
12. For example, a banking entity's investment in or relationship with a credit fund could be subject to the regulatory capital adjustments and deductions relating to investments in financial subsidiaries or in the capital of unconsolidated financial institutions, if applicable. *See* 12 C.F.R. § 217.22.
13. The Proposal would define "family customer" as (i) a family client, as defined in Rule 202(a)(11)(G)-1(d)(4) of the Investment Advisers Act of 1940 (17 C.F.R. § 275.202(a)(11)(G)-1(d)(4)) or (ii) any natural person who is a father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law or daughter-in-law of a family client, spouse or spousal equivalent of any of the foregoing.
14. The Proposal would define "closely related person" as a natural person (including the state and estate planning vehicles of such person) who has longstanding business or personal relationships with any family customer.
15. Such requirements include that an institution establish and maintain policies and procedures that are reasonably designed to manage credit exposure arising from the institution's intraday extensions of credit to affiliates. Additional guidance for compliance with this requirement can be found in Section 2020.1.8 of the Board's Bank Holding Company Supervision Manual, available at https://www.federalreserve.gov/publications/files/bhc.pdf.

Foreign Private Issuers: Annual Report Issues To Look for in 2020-21

By Guy P. Lander, Steven J. Glusband and Guy Ben-Ami

As companies continue to file their annual reports for fiscal 2019, we thought it would be a good idea to highlight what appears to be on the mind of the SEC staff these days as well as current trends. Specifically, we will only discuss issues that pertain to Foreign Private Issuers, or "FPIs." There are additional issues that domestic issuers should look out for.

As a reminder, foreign private issuers filing annual reports on Form 20-F must file their reports within four months after their fiscal year-end. For companies with a calendar year-end, the deadline this year was April 30, 2020.

For Canadian companies that are eligible to file a Form 40-F, if they file their audited financial statements and MD&A before the date on which the Annual Information Form, or "AIF," is filed in Canada, they are required to file their Form 40-F in the U.S. on the day the audited financial statements and MD&A are due to be filed in Canada. These companies should then file a 40F/A to add the AIF on the day the AIF is due to be filed in Canada. In any event the Form 40-F must be filed no later than the date that the relevant information is filed in Canada.

Current Risk Factors

Possible Trade War

FPIs, especially those with significant business in China, are starting to include a trade war risk factor. This risk factor is not limited to companies with significant business in China, as trade wars could escalate with other countries. Some companies have described how recent events, including the policies introduced by the current U.S. administration, have resulted in substantial regulatory uncertainty regarding international trade and trade policy. Several China-based FPIs have provided enhanced disclosure with respect to the related risks in their annual reports and other public disclosure documents.

Cybersecurity

Cybersecurity continues to be a very hot topic. FPIs must evaluate whether to disclose any cybersecurity risks or incidents in the MD&A (Item 5 of Form 20-F) as events reasonably likely to have a material effect on the FPI's results of operations, liquidity, or financial condition. FPIs are encouraged to describe material cybersecurity risks that are specifically related/applicable to each FPI's situation.

Brexit

FPIs are encouraged to pay attention to Brexit-related disclosures that disclose how they are dealing with Brexit's impact on the company's operations. The focus of the disclosure should be how management is dealing with Brexit risks, including new regulatory risks given the uncertainty of the legal framework that will apply to each industry, including supply chain risks due to potential trade disruptions, the risk of losing customers and revenue, exposure to exchange rate risks and contractual risks.

LIBOR

LIBOR is expected to be phased out by 2021. FPIs are beginning to take notice of disclosures related to the discontinuation of LIBOR and the potential impact of the discontinuation and the use of alternative benchmarks in the U.S. and elsewhere.

SEC Simplification of Disclosure and Compliance Requirements

The SEC has adopted several amendments designed to simply rules, reduce costs and burdens, improve the readability of documents, and discourage repetition and disclosure of immaterial information. FPIs should remember to use the new cover pages for both forms 20-F and 40-F, include as an exhibit to the 20-F a brief description of all registered securities, and follow the new guidelines of materiality for agreements and exhibits.

Inline XBRL

FPIs should be mindful of the upcoming inline XBRL requirement. Inline XBRL is a format that allows filers to embed XBRL data directly into a Hypertext Markup Language (HTML) document and is expected to reduce the

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likelihood of inconsistencies between HTML and XBRL filings and improve the quality of XBRL data.

FPIs will be required to comply with the Inline XBRL requirements based on their filer status and basis of accounting. For FPIs that prepare their financial statements in accordance with U.S. GAAP, the phase-in of the Inline XBRL requirements is determined based on its filer status: (i) large accelerated filers were required to comply with Inline XBRL for fiscal periods ending on or after June 15, 2019, and (ii) accelerated filers will be required to comply with Inline XBRL for fiscal periods ending on or after June 15, 2020. All other filers, including FPIs that prepare their financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB), will be required to comply with Inline XBRL for fiscal periods ending on or after June 15, 2021.

Critical Audit Matters (CAMs)

The requirement for auditors to disclose CAMs in their auditors' reports is based on the Public Company Accounting Oversight Board's (PCAOB) standard AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. Under the AS 3101, a CAM is defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (i) relates to accounts or disclosures that are material to the financial statements; and (ii) involves especially challenging, subjective, or complex auditor judgment. The inclusion of CAMs took effect for audits of fiscal years ending on or after June 30, 2019 for large accelerated filers and will take effect on December 15, 2020 for other issuers. Audit reports of "emerging growth companies" are not required to include CAM disclosures.

The standard was adopted to inform investors and other financial statement users about challenging matters in the audit and how they were resolved. Some factors to consider in assessing the auditor's judgment include: the risk of material misstatement, the degree of auditor judgment related to areas that involved significant judgment or estimation by management, whether the transaction is significant and/or unusual, the degree of auditor subjectivity in applying audit procedures, the nature and extent of audit effort required to address the matter, whether specialized skill or knowledge is needed and the nature of audit evidence obtained.

The following must be included in the audit report where a CAM has been identified: (i) identification of the CAM, (ii) a description of the principal considerations that led the auditor to determine the matter is a CAM, (iii) a description of how the CAM was addressed in the audit and (iv) a reference to the relevant financial statement accounts of disclosures. To date, all the audit reports that have been filed with the SEC by large accelerated filers have included at least one CAM.

> "FPIs, especially those with significant business in China, are starting to include a trade war risk factor. This risk factor is not limited to companies with significant business in China, as trade wars could escalate with other countries."

New Mining Property Disclosure Rules

On October 31, 2018, the SEC adopted final rules that overhaul the technical disclosure requirements applicable to companies engaged in material mining operations. Upon effectiveness, the new rules will replace the SEC's decades-old guidelines, set forth in Industry Guide 7 (Guide 7), with new subpart 1300 of Regulation S-K, based on the Committee for Mineral Reserves International Reporting Standards (CRIRSCO). As part of aligning disclosure requirements with the CRIRSCO standards, the rules require registrants with material mining operations to disclose, among other things: (i) information concerning mineral resources (the definition of which tracks CRIRSCO standards more closely and excludes oil and gas resources resulting from oil and gas producing activities, gases and water), which was previously only permitted in limited circumstances, (ii) material exploration results and related exploration activity and (iii) summary information concerning properties in the aggregate as well as more detailed information about individually material properties. Requiring the disclosure of mineral resources in addition to mineral reserves will provide investors with important information concerning the registrant's operations and prospects.

All SEC reporting companies, except those that file Form 40-Fs, will be required to comply with the new rules for their first fiscal year beginning on or after January 1, 2021. Foreign private issuers who file on Forms 20-F, F-1, F-3 or F-4 will no longer be permitted to include non-compliant disclosures in such filings. The SEC staff has explained that early voluntary compliance is permitted so long as a registrant satisfies all the provisions under Subpart 1300 of Regulation S-K and any required technical report is filed as an exhibit that meets existing EDGAR technical specification requirements. Industry Guide 7 will remain effective until all registrants are required to comply with the rules, at which time Industry Guide 7 will be rescinded. Registrants that do not voluntarily comply early with the new rules should use Industry Guide 7 for their mining property disclosures until compliance with the new rules is required.

NYSE Revises Exceptions to Shareholder Approval Rules

In March 2019, the SEC approved an amendment to the NYSE requirement that listed companies must obtain shareholder approval for certain share issuances (e.g., for issuances when the number of company securities to be issued by the company exceeds 20% of the number of shares outstanding or 20% of outstanding voting power).

Like the previously changed NASDAQ rule, the NYSE modification:

- changes the definition of market value for purposes of the shareholder approval rule to the lower of the closing price and five-day average closing price; and
- eliminates the requirement for shareholder approval of issuances at a price less than book value where the issuance price is at least as great as market value.

The SEC observed that, even with these changes, the ability of NYSE-listed companies to issue securities without shareholder approval continues to remain limited by other important NYSE rules, such as the rules requiring shareholder approval for change-of-control transactions and discounted issuances to insiders. However, FPIs can continue, if applicable, to use home country rules, and not comply with shareholder approval rules. Use of home country rules by an FPI requires proper disclosure and a written statement by an outside counsel that the FPI's home country does not have an equivalent to NASDAQ's or NYSE's rule and that its current practice is both legal and an accepted business practice in the FPI's home country.

SEC Proposal to Amend Financial Disclosure Requirements for Acquisitions and Dispositions

On May 3, 2019, the SEC proposed changes to the financial disclosure requirements for business acquisitions and dispositions intended to reduce the difficulty and expenses of preparing historical financial statements and pro forma financial information by amending Rule 3–05 and Article 11 of Regulation S–X.

The proposed amendments would not apply to target company financial statements required to be included in a proxy statement or registration statement on Form S–4 but would apply to the pro forma information provided therein pursuant to Article 11 and any financial information for other acquisitions and dispositions that would be required to be disclosed in the registration statement pursuant to Rule 3–05 or Rule 3–14.

SEC Proposal to Modernize Disclosures of Business, Legal Proceedings and Risk Factors

On August 8, 2019, the SEC proposed amendments to modernize provisions of Regulation S-K generally applicable to U.S. domestic reporting companies requiring description of business, legal proceeding and risk factor disclosures. The proposed amendments intend to improve the readability of disclosures for investors and simplify compliance requirements for companies, emphasizing a more principle-based approach, by focusing on information that is material to an investor's understanding of a company's business and eliminating redundant disclosures.

Although the proposal contemplates potentially incorporating parallel changes across all forms filed by FPIs, including annual reports on Form 20-F, the proposed changes regarding risk factors would apply to FPIs filing registration statements on Forms F-1, F-3 and F-4.

SEC Proposal to Disclose Payments Related to Extraction of Natural Resources

On December 18, 2019, the SEC proposed a rule to require resource extraction issuers to file an annual Form SD that includes information about payments related to the commercial development of oil, natural gas, or minerals that are made to a foreign government or to the U.S. federal government. This rule was mandated by the Dodd-Frank Act, but proposals were previously vacated by the courts and disapproved by Congress.

New proposed Rule 13q-1 requires that every issuer that files an annual report with the SEC on Form 10-K, Form 20-F or Form 40-F and engages in the commercial development of oil, natural gas, or minerals must furnish a report on Form SD.

Rule 13q-1 also provides that issuers may apply for the recognition by the SEC that an alternative reporting regime satisfies the transparency objectives of the Dodd-Frank mandate.

Rule 13q-1 exempts smaller reporting companies and emerging growth companies as well as issuers that have a conflict of law or a conflict with the provisions of a pre-existing contract, subject to meeting the stated conditions set forth in the rule.

SEC Proposal Regarding ICFR Auditor Attestation Requirement

Currently, all public companies (including FPIs) are required to have their management review the effectiveness of their internal control over financial reporting, or ICFR, under Section 404(a) of the Sarbanes-Oxley Act

(SOX). However, "accelerated" filers (market capitalization between $75 million and $700 million) and "large accelerated" filers (market capitalization greater than $700 million) are subject to an additional requirement under SOX 404(b). For these filers, including FPIs, an independent auditor must review and attest to management's internal assessment of the company's ICFR. Public companies that are not accelerated or large accelerated filers are exempt from ICFR auditor attestation requirements.

The SEC's proposed amendments, which were subject to public comment period until July 29, 2019, would provide a narrow carve-out from the current definitions of accelerated filer and large accelerated filer by excluding any company that both:

- Qualifies as a smaller reporting company; and
- Has less than $100 million in annual revenues during the most recent fiscal year for which audited financial statements are available.

Most significantly, these companies would no longer be subject to the SOX 404(b) auditor attestation requirement.

SEC Proposal to Further Simplify Management's Discussion and Analysis of Financial Condition and Results of Operations

On January 30, 2020, the SEC proposed significant changes to MD&A by adding new requirements, deleting requirements, simplifying instructions and revamping other requirements in an effort to streamline, avoid duplication of disclosure and allow issuers to better focus on disclosure of material information based on their facts and circumstances. Some of the proposed changes include:

(a) requiring issuers 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. The goal behind this proposal is 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 more important. The proposal would also add product lines as an example of other subdivisions that may need to be discussed where necessary to understand the business.

(b) requiring issuers 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 would use a disclosure threshold of "reasonably likely," which is consistent with the SEC's guidance on forward-looking statements.

"Accelerated" filers (market capitalization between $75 million and $700 million) and "large accelerated" filers (market capitalization greater than $700 million) are subject to an additional requirement under SOX 404(b).

(c) requiring issuers to disclose the reasons underlying material changes in net sales or revenues.

(d) eliminating the requirement to disclose off-balance-sheet arrangements in a separately captioned section. However, issuers would still be required to disclose material off-balance-sheet arrangements as part of the capital resources discussion.

(e) eliminating the Tabular Disclosure of Contractual Obligations. However, issuers would be required to discuss material cash requirements as part of their capital resources disclosure.

While these changes relate to Regulation S-K, the SEC is proposing conforming changes to Form 20-F and Form 40-F.

SEC Proposal to Expand Accredited Investor Definition

On December 18, 2019, the SEC proposed amendments to the definition of "accredited investor" as set forth in Rule 501(a) of the Securities Act of 1933. The proposed amendments would add new categories of natural persons that may qualify as accredited investors based on their professional knowledge, experience or certifications, and would also expand the list of entities that may qualify as "accredited investors."

The accredited investor definition is a central component of commonly used private placement exemptions from registration under the Securities Act, such as Rules 506(b) and 506(c) of Regulation D, and plays an important role in other federal and state securities law contexts.

Securities and Commodities Market Regulation of Latency Arbitrage

By Anthony Macchiarulo

Part 1: Latency Arbitrage

1. Overview

Latency arbitrage is the practice of capitalizing on the time delay of purchasing securities or commodities between exchanges. One of the most efficient latency arbitrage systems is one that trades between the disparities from the fragmentation of securities markets across multiple exchanges. For instance, if a high frequency trading (HFT) firm's algorithmic trading program detects that a stock's price has risen on one exchange, while remaining the same on another, the program will automatically buy the stock at its lower price at the second exchange while selling it at the higher price at the first.[1] The purpose of latency arbitrage is not to provide liquidity to markets but to trade between fragmented markets. Latency arbitrage shrinks up liquidity of financial markets and exploits retail trade flow. Market fragmentation refers to the hurdle trade order flow faces after submission by the end user or trader when navigating between multiple exchanges, dark pools, and electronic communication networks (ECN).[2] Market fragmentation degrades market quality as trades are scattered across multiple venues and investors lose opportunities to interact directly with one another. It also creates arbitrage opportunities that did not exist when trading markets were unified.[3]

On May 6, 2010, the Dow Jones Industrial Average (DJIA) fell by nearly 1,000 points over the course of several minutes and then quickly rebounded, which was known as "the flash crash." This was one of the largest intraday declines in the history of the DJIA and exposed many flaws in the structure of the market. This event led to several analytical studies and reports and to greater scrutiny of HFT. After the October 1987 market crash, when the DJIA lost almost 22% in a single day, the SEC was delegated responsibility for investor protection through mandatory disclosure and maintaining fair and orderly markets. Some research has concluded that algorithmic trades are correlated, which raises the concern shocks that hit a small number of active HFT traders could detrimentally affect the entire market and increase systematic risk.[4]

Policy makers believe the cure for fragmentation, i.e., consolidating markets, is worse than fragmentation because consolidation will eliminate competition, lower innovation, raise transaction costs, and deter trading activity. The remedy proposed is to create multiple trading venues and then limit trading in a particular security to one of them. For example, each licensed stock exchange could split the number of securities traded on it. This would create an exclusive and centralized forum for trading and would create exchanges that are large enough to benefit from scale, yet numerous enough to compete for listings.[5]

2. Building a Latency Arbitrage System

The Consolidated Tape Association (CTA) oversees the dissemination of real-time trade and quote information in New York Stock Exchange LLC ("Network A") and BATs, NYSE Arca, NYSE American and other regional exchange ("Network B") listed securities. All SEC-registered exchanges and market centers that trade Network A or Network B securities send their trades and quotes to a central consolidator where the Consolidated Tape System (CTS) and Consolidated Quote System (CQS) data streams are produced and distributed worldwide.[6] These plans were approved by the Securities and Exchange Commission under Section 11A of the Securities Exchange Act of 1934.[7] Investors that place orders stream into exchanges, which are required to feed summary information about their best buy and sell orders to the Security Information Processor (SIP). The SIP is under the jurisdiction of the CTA. The SIP continually updates public price quotes called the National Best Bid and Offer (NBBO). The SIP disseminates and calculates the NBBO, Limit Up Limit Down (LULD), short sale restrictions, and regulatory halts. SIP publishes data to the NBBO and LULD at a median latency of about 230 microseconds per transaction.[8]

The NBBO is a SEC regulation requiring brokers to trade at the best available ask price and the best available bid price when buying and selling securities for customers. The NBBO is the bid or ask price that the average customer will see. The SEC's Regulation NMS requires that brokers guarantee their customers this price.[9]

HFTs generally invest in specialized infrastructure to directly connect to exchanges and process orders faster than other brokerages, which is known as "direct market access." Direct market traders do not rely on SIP data for their buy/offer bids, but rather profit on the latency between calculation of the NBBO and its publishing to brokers. There has been argument that this practice is essentially the same as front running orders.[10]

Due to the speed that data is transmitted to the NBBO, algorithms based on a latency arbitrage model need to be able to gain access to the data at a faster rate

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than 230 milliseconds, i.e., the average speed at which data is updated bythe SIP. Latency is measured in units of time, i.e., hours, minutes, seconds, nanoseconds or clock periods. Throughout is the number of such actions executed or results produced per unit of time. There are a few software and hardware tricks HFT firms use to lower latency time.[11]

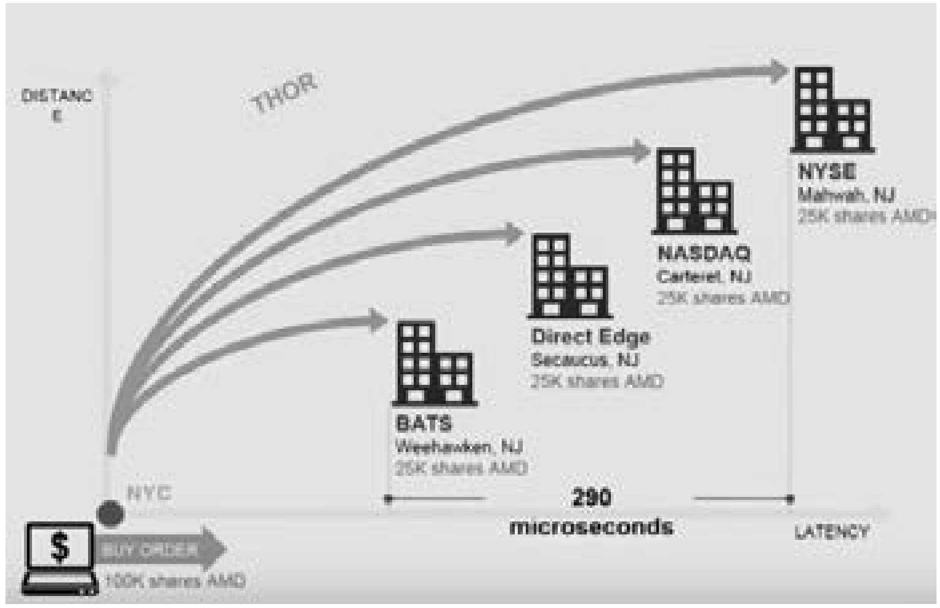
HFT firms build their algorithms on field programmable gate arrays (FPGA) as opposed to central processing units (CPU) used in standard computers because FPGA hardware operates faster for repetitive tasks, such as trading the same strategy a million times per second. FPGA is a chip containing millions of logic blocks repeated throughout the silicon. Each of these logic cells is called a lookup table (LUT), which includes basic logical operations. To form an algorithm, LUTs are connected to each other in a specific order by configurable switches. Both LUTs and the surrounding fabric are programmable, providing a flexible system for HFT that choose to trade different strategies or products.[12]

HFT firms want to connect to exchanges in the fastest way possible. Therefore, the type of cabling used is paramount.[13] Anova Financial Networks created the laser network with microwave cabling between the NYSE and NASDAQ which provides 94.5µs one-way latency speed (0.0945 milliseconds) between trading venue and location. Microwave cabling has been shown to lower the time it takes for data to travel.[14]

Submitting orders directly to the execution venue bypasses the time it takes standard investors to place orders through their brokers. Under the fragmented trading model, when an investor places a trade, the broker looks at the size and availability of the order to decide which path is the best way for it to be executed. A broker can fill an investor's order by either direct order to the exchange, market maker transaction, internalization, i.e., the broker's own inventory, or through an ECN. This directing of trade volume slows the execution process down.[15] After a broker receives an investor's trade, based on the location of the investor's computer, the order will be routed to the closest exchange available.

For example, an investor based in downtown Manhattan that purchases 100,000 shares of Advanced Micro Devices, Inc. (AMD) will first be routed to BATs, i.e., the closest exchange available. In this hypothetical, the problem is BATs only has inventory of 25,000 shares. Therefore, the next 26,000 lot of shares must be purchased at the second nearest exchange. The latency arbitrage algorithm, which may be co-located to each of the exchange servers, will purchase the remaining shares from the further exchanges at a lower price and then sell them to the original investor for a higher price or the order will not fill. In a basic sense, the diagram below showcases how latency arbitrage systems earn a profit. Among the four exchanges depicted here, it only takes 290 microseconds, but the HFT algorithms are faster.[16]

Table 1.[17]



The distance between the exchange and the trading system and the distance between the two trading venues are paramount to HFT capitalizing on latency arbitrage systems. The closer to the exchange the firm's FPGA based algorithm, the faster the firm can front run trades and profit before a retail investor can. HFTs use co-location to minimize latency time. Co-location refers to locating computers owned by HFT firms and proprietary traders in the same premises where an exchange's computer servers are housed. This enables HFT firms to access stock prices a split second before the rest of the investing public.[18]

Co-location has become a lucrative business for exchanges, which charge HFT firms millions of dollars for low latency access. As Michael Lewis explains in his book *Flash Boys*, the huge demand for co-location is a major reason why some stock exchanges have expanded their data centers substantially. While the old New York Stock Exchange (NYSE) building occupied 46,000 square feet, the NYSE Euronext data center in Mahwah, New Jersey is almost nine times larger, at 398,000 square feet.[19]

3. Barclays Liquidity Cross and High Frequency Trading Litigation

Barclays Liquidity Cross and High Frequency Trading Litigation ("Barclays Opinion") involved a multi-district litigation (MDL) proceeding. In four cases, originally filed in the Southern District of New York, various investors brought claims under the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq*., against seven stock exchanges, i.e., BATS Global Markets, Inc., Chicago Stock Exchange, Inc., Direct Edge ECN, LLC, the NASDAQ Stock Market LLC, NASDAQ OMX BX, Inc., New York Stock Exchange, LLC, and NYSE Area, Inc. (collectively, "the Exchanges") as well as Barclays PLC and Barclays Capital Inc. (collectively, "Barclays"). In a fifth action, Docket Number 15–CV–168, filed in the United States District Court for the Central District ofCalifornia, Plaintiff Great Pacific Securities ("Great Pacific") sued Barclays alleging violations of California state law in connection with operation of their dark pool.[20]

The primary Defendants in this case, the Exchanges, are all self-regulatory organizations (SROs) under the Securities & Exchange Act.An SRO is an organization that exercises jurisdiction over its own industry and refers to any national securities exchange, registered securitiesassociation, or registered clearing agency.[21] Exchanges are registered with the SEC pursuant to Section 6(a) of the Securities Exchange Act.[22]

SROs are private entities that exercise regulatory authority delegated to them by the SEC, subject to extensive SEC regulation.[23] The Exchanges remain SROs even though they are now for-profit corporations, a status that the SEC authorized in 1998.[24] The SDNY Plaintiffs challenged three practices the exchange defendants operated in this case. These charges included co-location services; proprietary data feeds; and complex order types.[25]

A. Co-Location

The first argument posed by the plaintiffs was co-location. The court held absolute immunity does not apply to the co-location services offered by exchanges. The court argued that co-location services do not serve a regulatory function or differ from the provision of commercial products and services that courts have held not to be protected by absolute immunity in other cases.[26]

The SEC does not prohibit exchanges from offering co-location and direct data feed services. The SEC requires exchanges offering co-location and direct data feeds to do so on terms that are "fair and reasonable," and not "unreasonably discriminatory."[27] Exchanges offering co-location services must also have an SEC-approved exchange rule in place governing those services. The court held that plaintiffs failed to explain how enabling HFT firms to transact more quickly to existing trading information could constitute a manipulative act when "the services at issue are publicly known and available to any customer willing to pay."[28]

Since the exchanges gave full disclosure and did not fail to omit material information regarding their co-location services, they would not run afoul of neither the SEC Rule 10b-5 or the CEA Rule 180.1 anti-fraud provisions of the Securities Exchange Act and the Commodities Exchange Act respectively, provided that their co-location services were fair and reasonable and not unreasonably discriminatory.

B. Complex Order Types

The second argument posed by the plaintiffs was with respect to complex order types. The court held that exchanges are absolutely immune for their creation of complex order types. The order types permitted by an Exchange define the ways in which traders can interact with that Exchange.[29] By establishing a defined set of order types, the Exchanges police the ways in which users of an exchange are able to interact with each other. In so doing, the order types establish a framework by which buyers of stocks are matched with sellers.[30]

The plaintiffs contended that the complex order types at issue were outside of the Exchanges, capacity as SROs because they were created for business purposes and at the request of the HFT firms. They further asserted the complex order types were products and that the Exchanges did not have immunity for the development of a product.[31] However, the court held the act of creating a product has a regulatory dimension, and an exchange is immune from suit based on that product.[32]

C. Proprietary Data Feeds

The third argument posed by the plaintiffs was with respect to proprietary data feeds, which the court held fell within the scope of quasi-governmental powers delegated to the exchanges. Significantly, the SDNY Plaintiffs effectively conceded that the dissemination of market data regarding transactions on the Exchanges through the consolidated feed was regulatory in nature.[33]

The court held Congress and the SEC have delegated to the exchanges the task of disseminating market data as part of a national market system (NMS). In doing so through proprietary data feeds, the exchanges are performing that task no less than when they do so through the consolidated feed. That is, the dissemination of market data through the propriety data feeds is consistent with the quasi-governmental powers delegated to the exchanges pursuant to the Securities Exchange Act of 1934 and SEC regulations.[34]

D. Barclay's Dark Pool Operation

The fifth case against Barclays focused on Barclays operation of dark pools. Plaintiffs contended that, by providing proprietary feeds and co-location services at prices that only HFT firms could afford, Barclays set out to capture this trading volume by rigging its dark pool in favor of the HFT firms.[35] The alleged scheme consisted of two broad components. First, Barclays allegedly disclosed to HFT firms important, otherwise non-public information regarding transactions in the dark pool. For example, it provided at least some HFT firms with the "logic" of the servers operating the dark pool, which enabled those firms to refine their aggressive trading strategies.[36]

Plaintiffs also alleged Barclays either failed to establish or actively undermined various protections for ordinary investors using its dark pool. For example, Barclays allegedly overrode its liquidity profiling product so that certain HFT firms would appear less aggressive and, therefore, would not be blocked by investors that sought to block aggressive firms from trading against them in the dark pool.[37]

Further, plaintiffs alleged Barclays provided co-location services that could be used effectively only by HFT firms.[38] Despite taking those actions to benefit the HFT firms, thereby enabling them to exploit ordinary investors, Barclays represented its dark pool was safe and the SDNY Plaintiffs were not at risk of being exploited by HFT firms. Plaintiffs alleged, as a result of these actions, the plaintiffs traded on worse terms in the dark pool than they would have in a fair and unmanipulated market.[39]

The court held the plaintiffs failed to state manipulative-scheme claims against the stock exchanges under Section 10(b) and Rule 10b–5 based on exchange provision of co-location services and proprietary data feeds. Absent any manipulative acts on the part of the exchanges, the complaint failed to allege that the exchanges misrepresented or failed to disclose material information regarding either proprietary data feeds or co-location services, the exchanges did not conceal the availability of proprietary data feeds and co-location services, both of which were publicly approved by the SEC, and the exchanges alleged acts were not violations of the Securities Exchange Act of 1934 since they merely enabled high-frequency trading firms to execute transactions which caused only an allegedly artificial effect on the market.[40]

E. Holdings

In conclusion, the court held exchanges are absolutely immune from suit based on their creation of complex order types and proprietary data feeds, both of which fall within the scope of the quasi-governmental powers delegated to the exchanges.

The court emphasized that plaintiffs had failed to explain how merely enabling HFT firms to transact more quickly could constitute a manipulative act when the services at issue were publicly known and available to any customer willing to pay.

Further, the court held the plaintiffs failed to state manipulative-scheme claims against the stock exchanges under Section 10(b) and Rule 10b–5 based on the exchanges provision of co-location services because the exchanges did not engage in manipulative acts and had disclosed, and not omitted, all material information regarding their co-location services and data feeds.

The court concluded that any market impact was caused by the HFT firms themselves, and not by th exchanges. The court provided that merely facilitating trades by an HFT firm that separately commits a manipulative or deceptive act was not sufficient to establish legal liability on the part of the exchanges.

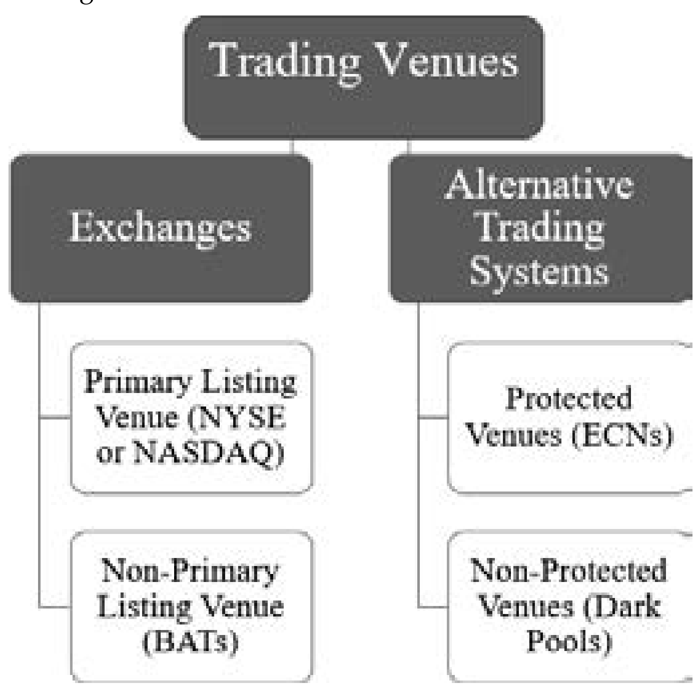
Part II. The Securities Exchange Act

1. Equity Market Framework

Trading venues are broadly classified as either Exchanges or Alternative Trading Systems (ATS). Section six of the Securities Exchange Act of 1934 requires exchanges to register with the SEC.[41] Two types of exchanges are primary listing venues and non-primary listing venues. Primary listing venues operate as either an auction market between individuals such as the NYSE or as a dealer's market between dealers such as NASDAQ. Non-primary listing venues, such as BATs, operate depository receipt programs, which handle custody, currency exchange, and local tax issues for foreign based securities to trade in the U.S.[42]

ATSs include protected venues such as Electronic Communication Networks and non-protected venues such as Dark Pools. ECNs are electronic trading systems that automatically match buy-and-sell orders at specified prices and ECNs are also required to register with the SEC as broker-dealers and are subject to market regulations. ATS subscribers, which are typically institutional investors, broker-dealers and market-makers, can place trades directly with an ECN, known as direct market access. Individual investors must have an account with a broker dealer subscriber before their orders can be routed to an ECN for execution.[43]

A dark pool is the portion of liquidity created by institutional orders that are not openly available to the public. The purpose of dark pools is to minimize price change impact by preventing pre-trade information leakage. Market participants lack crucial information about how dark pools function. The SEC require certain ATSs to undergo review to ensure they qualify for the exemption from registering as an exchange.[44] Below (figure 1) is the trading venue framework.



2. SEC Rule 10b-5

SEC Rule 10b-5, promulgated by the SEC pursuant to its authority granted under § 10(b) of the Securities Exchange Act of 1934 and codified as 17 C.F.R. 240.10b-5, targets securities fraud. The rule provides it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[46]

The SEC has brought enforcement actions against HFT firms based on their fraudulent trading activities to manipulate close prices of securities using latency arbitrage on all the trading venues discussed above. On October 16, 2014, the SEC brought the first HFT manipulation case against a New York City-based high frequency trading firm, known as Athena Capital Research, for placing a large number of aggressive, rapid-fire trades in the final two seconds of almost every trading day during a six-month period, to manipulate the closing prices of thousands of NASDAQ listed stocks. Athena Capital Research used an algorithm, which they named "Gravy," to engage in a practice known as "marking the close," in which stocks are bought or sold near the close of trading to affect the closing price.

The large volumes of Athena's last-second trades allowed Athena to overwhelm the market's available liquidity and artificially push the market price and therefore the closing price in Athena's favor. Athena was aware of the price impact of its algorithmic trading, calling it "owning the game" in internal e-mails, which proved the scienter element of Rule 10b-5. Athena agreed to pay a $1 million penalty to settle the SEC's charges.[47]

Here, every day at the close of trading, NASDAQ runs a closing auction to fill all on-close orders at the best price, one that is not too distant from the price of the stock just before the close. Athena placed orders to fill imbalances in securities at the close of trading, and then traded shares on the continuous market on the opposite side of its order. As discussed in the Barclays Opinion, using latency arbitrage to fill complex order types is not the liability of the exchanges since they are immune as SROs, but the individuals engaging in these practices may still be subject to market manipulation and securities act claims in the equity markets.

3. Regulation National Market System

The Securities Acts Amendments of 1975 is an act of Congress, which was passed on June 4, 1975 and amended the Securities Act of 1933 and the Securities Exchange Act of 1934. The law empowered the SEC to establish a national market system and a system for nationwide clearing and settlement of securities transactions, enabling the SEC to enact Regulation NMS.[48]

Regulation NMS was established in 2005 by the SEC as designed to modernize and strengthen the National Market System for equity securities. Regulation NMS is intended to assure that investors receive the best NBBO price executions for their orders by encouraging competition in the marketplace.[49]

The SEC does not prohibit exchanges from offering co-location and direct data feed services as discussed in the Barclays opinion. The SEC requires exchanges offering co-location and direct data feeds to do so on terms that are "fair and reasonable," and not "unreasonably discriminatory."[50] Exchanges offering co-location services must also have an SEC-approved exchange rule in place governing those services.[51]

Further, Regulation NMS Rule 603(a) prohibits exchanges from independently transmitting their own data any sooner than they transmitted data to a processor for inclusion in the consolidated tape.[52] However, under Rule 603(a) of Regulation NMS, the SEC admitted information in the data feeds of exchanges generally reaches market participants faster than the same information in the consolidated tape because of the time required to consolidate data from multiple exchanges and distribute it to the public.

On May 1, 2014, the SEC brought an enforcement action against the NYSE for offering co-location without any SEC-approved exchange rule in place governing that service.[53] The SEC also brought an enforcement action against the NYSE in 2012 for violating Regulation NMS Rule 603 by providing information to individual data feeds before sending it to the processor for inclusion in the consolidated tape.

Here, high-frequency proprietary trading firms facing allegations of insider trading may be able to use these facts to argue that market information obtained through co-location and direct data feed arrangements is public information. Although exchanges are considered SROs, they are still subject to Regulation NMS and enforcement by the SEC.

Part III. Securities and Exchange Commission

1. Market Information Data Analytics System (MIDAS)

In 2010, the SEC released its first comprehensive exploration of the public policy implications of HFT. The document was termed the SEC Concept Release on Equity Market Structure.[54] The release was aimed at establishing the framework for the nation's equity market structure. The release sought public comment on a range of issues that had arisen after SEC implementation of Regulation NMS. [55]

In 2013, the SEC adopted MIDAS, the trade monitoring system that captures all orders posted on the national exchanges, all modification and cancellation of those orders, all trade executions of those orders, and all off-exchange executions. MIDAS helps the SEC monitor and understand flash crashes and illegal behavior. One example of how MIDAS is used is to alert the SEC to excessive order cancellations and detect spoofing.[56]

MIDAS collects more than one billion records per day from each of the national equity exchanges, each time-stamped to the microsecond. For the first time, the SEC had access to data about every displayed order posted in the national exchanges in near real time. MIDAS allowed the SEC to counter latency arbitrage activity more efficiently.[57]

2. Consolidated Audit Trails

In 2012, the SEC adopted the Consolidated Audit Trail, which requires all stock exchanges to create a uniform system for tracking the life cycle of all orders and trades. With the audit trail in place, the SEC is able to receive real time access to most of the data needed to reconstruct a market dislocation such as a flash crash.[58]

The large trader reporting rule was adopted by the SEC in 2011. It imposed SEC registration and reporting requirements on large traders, which it defines as entities who trade either 2 million shares or $20 million during any calendar day; or 20 million shares or $200 million during any calendar month. This allows the SEC to assess the impact of large trader activity on the securities markets; reconstruct trading activity following periods of unusual market volatility; and analyze significant market events for regulatory purposes.[59]

3. Naked Access

Before the Flash Crash, many HFT firms gained special access to securities exchanges through "naked access," a process through which SEC-registered brokers allowed the firms to piggyback on their direct access to securities markets. The arrangement enabled the firms to reduce their trade latency while avoiding the various risk, checks, and capital requirements, which they would have needed to comply with had they been registered brokers.[60] In 2010, the SEC adopted a new rule aimed at the registered brokers, Rule 15c3-5, which essentially prohibited HFT firms from receiving naked access.[61] Under Rule 15c3-5, every broker dealer needs to meet a minimum capital requirement. Broker dealers require the greater of $250,000 or 2% of aggregate ineptness, i.e., 2% of margin owed by the customer.

Further, in 2012, the SEC adopted a "limit up-limit down" mechanism to replace the single-stock circuit breaker rules. Because single-stock circuit breakers are triggered after a trade occurs at or outside of the applicable percentage threshold, circuit breakers have been triggered by erroneous trades.[62] The new limit up-limit down mechanism is intended to prevent trades in individual securities from occurring outside of a specified price band, which will be set as a percentage level above and below the average price of the stock over the immediately preceding five-minute trading period.[63]

> "MIDAS helps the SEC monitor and understand flash crashes and illegal behavior. One example of how MIDAS is used is to alert the SEC to excessive order cancellations and detect spoofing."

Part IV. Financial Industry Regulatory Authority (FINRA)

1. Order Audit Trail System (OATS)

Under FINRA Rules 7410 through 7470 or NASD Rules 6950 through 6958, FINRA member firms are required to develop a means for reporting the execution of orders, including recording all times of these events to FINRA. These rules apply to all FINRA member firms.[64]

The purpose of OATS is to record information relating to orders, quotes, and other related trade data from all equities traded on the National Market System. Neither traders nor investors have the obligation to report, but the member firms do. Additionally, ATSs and dark pools have to report this data to FINRA.[65] FINRA established OATS to monitor the trading practices of member firms and to guard against market manipulation. The OATs system can help indicate unusual activity in the market and indicate illegal latency arbitrage activity.[66]

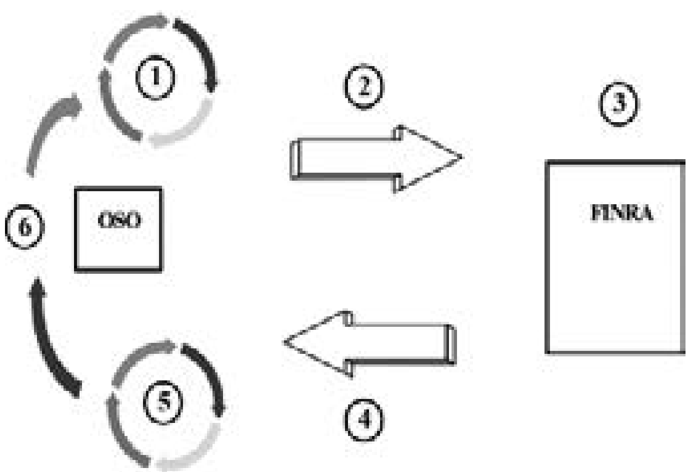
2. Trade Reporting and Compliance Engine

Most over the counter transactions are not publicly reported. To increase transparency, the SEC under Rule 6200 instituted the Trade Reporting and Compliance Engine (TRACE). TRACE is a platform that gathers over the counter information and reports it to the public. FINRA member firms were mandated under Rule 6200 to report trades in fixed income and over the counter securities starting in 2001.[67], [68]

In *Bruce v. Suntech Power Holdings Co.*, shareholders filed putative securities fraud class actions against the Chinese manufacturer of solar energy products and its officers, alleging that the company had falsely disclosed that it had been the victim of fraud, in violation of the Securities Exchange Act. In the case, Suntech's shares were traded on the NYSE while their convertible notes were traded and reported on FINRA's TRACE system. Plaintiffs alleged that they suffered loss due to Suntech's failure to disclose the bonds were borrowed from a third party.

Here, without FINRA's TRACE system, the plaintiffs in this case would have not been able to identify the convertible notes. Plaintiffs defeated the defendant's motion to dismiss, and the complaint wassuccessful in establishing scienter.[69] The TRACE system is shown to work as below (figure 2), where Order Sending Organizations (OSO) generate Reportable Order Events (ROE) records and package them in firm order report files. OSOs are also able to enter the ROEs directly in the OATS Web Site.[70]

Figure 2[71]



3. Smart Order Routing Identification

FINRA guards against specific types of high frequency trading. The primary offenses FINRA monitors are front running, spoofing, and layering.[72] FINRA is able to safeguard against these practices by linking the source transactions and by assigning unique identifiers to each trade. Unique identifiers travel throughout the entire trade lifecycle and can be traced to origin to help detect fraud. A few identifiers FINRA uses are Trade Date or Order Sent Date, Exchange Code or Sent to Firm MPID, Order Entry Firm Identifier, Issue Symbol ID, Routed Order ID, and Connection ID. By monitoring the entire trade lifecycle, it becomes easier to identify fraud by algorithms.[73]

Front-running refers to making a trade based on nonpublic advance knowledge of a large transaction. This practice is banned by the SEC and FINRA. In the debate around HFT, the term front-running has been used by some to characterize a practice where HFT firms deploy algorithmic trading technology to detect large incoming orders for a security, and then automatically buy the security before the original large orders are completed. Almost immediately after they buy the securities, the HFT firms can then profit by selling the securities to the original investors at higher prices as described in part one of this article. While such conduct may not be unlawful if not based on material non-public information, there are questions about the value it provides and the extent to which it should be regulated. As discussed in the *Barclays* opinion, the practice is not banned on a latency arbitrage basis unless it leads to market manipulation.[74]

Spoofing is an illegal trading tactic that involves the manipulation of a security's price to profit off the resulting price movement. The spoofing trader puts in a large order to buy or sell a security at an artificial price. Market participants who see that order may also offer to buy or sell the security at the same price.[75] The trader then cancels his or her order and takes advantage of others' offers, buying the security at a below-market price and selling it at an above-market price. Layering or complex ordering is a form of spoofing in which a trader places multiple orders at varying price points, to create a false impression of the amount of interest in that security. The trader places new buy or sell orders to take advantage of the artificially low or high prices.[76]

Spoofing was explicitly addressed by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, and even before then FINRA rules prohibited the use of manipulative or deceptive quotations, but published reports indicate that spoofing continues to distort securities pricing.[77]

Here, FINRA safeguards against these practices by linking the source transactions and by assigning unique identifiers to each trade. Unique identifiers travel throughout the entire trade lifecycle and can be traced to origin to help detect fraud by algorithms.[78]

Part V. Commodity Exchange Act

1. Commodity Market Framework

The Commodity Exchange Act (CEA) gives the CFTC enforcement authority to establish regulations under Chapter I Title 17, of the Code of Federal Regulations. Passed by the U.S. government in 1936, the CEA replaced the Grain Futures Act of 1922.[79] The commodity market is regulated by the CEA and the CFTC. This includes the regulation of futures, forwards, swaps, and derivatives on commodity products. The types of traders in the derivative market are classified as either hedgers or speculators.

Hedgers have a position in the underlying commodity. They use futures to reduce or limit the risk associated with an adverse price change. Producers, such as farmers, often sell futures on the crops they raise to hedge against market fluctuations in commodity prices. This makes it easier for producers to do long-term planning. Similarly, consumers such as food processing plants often buy futures to secure their input costs. Two people who use derivatives are known as bona fide hedgers.[80]

Many speculators are individuals trading their own funds. Traditionally, individual traders have been characterized as individuals wishing to express their opinion about, or gain financial advantage from, the direction of a particular market. Electronic trading has helped to level the playing field for the individual trader by improving access to price and trade information.[81] One way the CFTC enforces speculator activity is through speculation limits. These limits require each speculator to only hold a certain number of contracts per position. This allows for a much lower amount of market manipulation in the commodity market by way of latency arbitrage because it makes it more difficult for speculators to determine price action.[82]

Although the primary regulation of the CEA includes regulation of futures, forwards, swaps, and derivatives on commodity products, there are also specialized products that are under the supervision of the CFTC and are changing every day. Specialized contracts include exchange of futures for physicals (EFP), exchange of futures for swaps (EFS), non-deliverable forward (NDFs), and contract for differences (CFD), which all may be transacted off the exchange. Exchanges do not like this type of activity but must regulate it and enforce disclosure of these products. Before Dodd Frank was enacted, this type of activity was not regulated; however, after Dodd Frank, this activity has become regulated as swaps.[83]

2. CEA Rule 180.1

CEA Rule 180 codified as 17 CFR § 180.1 provides for the prohibition of the employment, or attempted employment, of manipulative and deceptive devices. The rule is regarded as the 10b-5 equivalent in commodities regulation by which the CFTC provides for enforcement actions. The rule provides: (a) It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly: (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud; (2) Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading; (3) Engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person; or, (4) Deliver or cause to be delivered, or attempt to deliver or cause to be delivered, for transmission through the mails or interstate commerce, by any means of communication whatsoever, a false or misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate. Notwithstanding the foregoing, no violation of this subsection shall exist where the person mistakenly transmits, in good faith, false or misleading or inaccurate information to a price reporting service.[84]

The CFTC may bring enforcement actions against individuals under 17 CFR § 180.1 due to market manipulation such as spoofing. In *Braman v. The CME Grp., Inc*, the plaintiffs alleged that after January 1, 2005, the defendants began to allow certain HFTs to use an exploitable structural advantage known only to defendants that existed at the CME called the Latency Loophole, which when coupled with receiving price information faster than all the exchange defendants' other customers, would allow these select firms to exploit the order flow of all the other customers and users of the exchange's trading markets. According to plaintiffs, the latency loophole, or latency gap, was the gap in time between when an HFT with direct market access can see that it made a trade and at what price and when the rest of the world is made aware of this trade.[85] Much like the Barclays opinion, the CEA precludes investors from pursuing a private right of action against contract markets for providing false information.[86]

Here, to plead fraud by manipulative conduct under CEA, the plaintiff must plead what manipulative acts were performed, which defendants performed them, when the manipulative acts were performed, and what effect the scheme had on the market for the commodities at issue.[87] Much like the securities market, commodity exchanges are protected as SROs and are immune from most private causes of action. Although this may be the case on the exchange side, the CFTC can still pursue 17 CFR § 180.1 causes of action against funds for manipulating the derivative markets.

3. Supervised Parties

Parties that are under the jurisdiction of the CEA include Future Commission Merchants (FCM's), Introducing Brokers (IB), Swap Dealers, Commodity Trading Advisors (CTA), Commodity Pool Operators (CPO), Retail Foreign Exchange Dealers (RFED), and Associated Persons (AP).[88]

An FCM is an entity that solicits or accepts orders to buy or sell futures contracts, options on futures, retail off-exchange forex contracts or swaps, and accepts money or other assets from customers to support such orders. Swap Dealers are dealers that engage in swaps.[89] IBs are similar to FCMs with the exception that only FCMs can hold customer funds. FCMs have a larger net capital requirement. IBs do not have large capital requirements. An IB deals directly with the client. Trade execution and back office work are the responsibility of the FCM. CTAs give investment advice to customers on derivatives, and the equivalent in the securities world is an investment advisor (IA).[90]

CPOs are normally operated as hedge funds that trade futures or swaps. An entity that creates a commodity fund has to register as a CPO. A CPO is defined as an individual or organization that solicits or receives funds to use in the operation of a commodity pool, syndicate, investment trust, or other similar fund, specifically for trading in commodity interests. Every CPO takes the money of multiple customers and pools it together for the purpose of trading futures contracts and other CFTC regulated instruments. RFED's deal in foreign exchange with retail customers and must either register as an FCM or RFED.[91] Finally, AP's are employed by either an FCM, IB, CTA, or CPO and solicit customers and deal with customers daily.[92]

The court in *CFTC v. Wilson* held a commodity investment manager was required by the CEA to register as a CPO; the CPO's false statements to pool participants violated the CEA's general anti-fraud provision; and the appropriate measure of civil penalty was a statutory per-violation amount, rather than the trebling of investors' losses.[93] Here, all entities that operate in the commodities market are subject to CFTC enforcement regulation and are subject to CEA Rule 180.1. The CFTC makes it difficult by way of registration for entities to defraud the market with latency arbitrage.

Part VI. Commodity Futures Trading Commission (CFTC)

1. Disruptive Trading Regulation

On May 16, 2013, the CFTC issued guidance on disruptive trading practices, which touches on issues that may involve HFT. Section 747 of the Dodd-Frank Act amended the CEA to prohibit disruptive trading practices in futures, options, or swaps trading. Among other changes, Section 747 amended CEA Section 4c(a)(5) to outlaw spoofing bidding or offering with the intent to cancel the bid or offer before executing a trade. One study of HFT by the Swedish financial regulatory authority in 2012 found that spoofing was associated with HFT, at least in the experiences of traders, and that market participants believed it was being used to manipulate the prices for some financial instruments.[94]

Section 747 of the Dodd-Frank Act specifically prohibits certain disruptive trading practices, which are defined as any practice that: violates bids or offers; demonstrates intentional or reckless disregard for orderly execution; or is of the character of, or is commonly known to the trade as, "spoofing," i.e, bidding or offering with the intent to cancel the bid or offer before execution.[95]

In May of 2013, the CFTC prohibited spoofing on any futures exchange or swap execution facility as long as the canceling of the bids and offers trade execution was intentional, rather than the result of reckless, negligent or accidental behavior.[96], [97]

2. Dodd Frank Reform

The Dodd-Frank Act created a new financial regulatory oversight body, called the Financial Stability Oversight Council (FSOC). The Act gives the FSOC authority over all other financial regulatory agencies of the federal government, in order to regulate systemic risks posed by large financial institutions. The Dodd-Frank Act requires the FSOC to focus on large institutions that could by themselves pose threats to national economic stability, which were dubbed during the financial crisis as "too big to fail."[98]

The Secretary of the Treasury chairs the FSOC, with voting members including the chairman of the Board of Governors of the Federal Reserve, the chairpersons of the SEC, CFTC, the National Credit Union Administration Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (OCC), the director of the Federal Housing Finance Agency, and the Consumer Financial Protection Bureau, and a presidential appointee with insurance expertise.[99]

On July 22, 2013, the CFTC announced its first enforcement order and settlement for spoofing under the Dodd-Frank Act's Section 747 prohibition of disruptive trading practices, when it fined Panther Energy Trading LLC of Red Bank, New Jersey, and Michael J. Coscia of Rumson, New Jersey, $1.4 million for engaging in the disruptive practice of spoofing by utilizing a computer algorithm that was designed to illegally place and quickly cancel bids and offers in futures contracts.[100]

The May 2013 CFTC guidance also prohibits a person from buyinga derivatives contract on an exchange or swap execution facility at a price that is higher than the lowest available price offered for such contract or selling such contract at a price that is lower than the highest available price bid.[101] This practice is termed violating bids and offers, and the CFTC required no intentional behavior to constitute a violation.[102],[103]

3. Regulation Automated Trading ("Reg AT")

On November 24, 2015, the CFTC released a proposed rule, Reg AT, governing HFT practices.[104] In this regulation, the CFTC also referred to governing algorithmic trading systems frequently.[105]

The futures exchanges, also known as Designated Contract Markets ("DCM"), are where most automated trading takes place. Most futures exchanges have indicated in their public materials order times of less than one millisecond in which trades can be executed.[106]

Under Reg AT, DCMs are required to support risk controls and compliance checks for all users accessing their platforms, which includes exchange members, FCMs and IBs providing automated trading and clearing services to non-members through direct access. Reg AT requires in part (i) new definitions for algorithmic trading, such as algorithmic traders ("AT Persons") and direct access in the U.S. futures markets; (ii) pre-trade risk controls for all AT Persons, FCMs and DCMs for automated trades; (iii) registration requirements for direct connectivity to U.S. based FCMs and exchanges by all AT Persons; and (iv) mandatory algorithm source code repositories for all automated trading systems.[107]

On November 4, 2016, the CFTC, in a two-to-one vote, approved a supplemental proposal on the regulation of automated trading. Specifically, the Supplemental Proposal includes six significant changes to the proposed regulatory framework for automated trading: (1) revised pre-trade risk controls requirements; (2) a new volumetric threshold for qualification as an "AT Person;" (3) a broader definition of "Direct Electronic Access" (DEA); (4) clarification regarding the retention of source code; (5) an alternative compliance pathway via certification for parties using third-party Automated Trading Systems; and (6) an elimination of the annual reporting requirements for AT Persons and clearing member FCMs and review requirements for DCMs proposed under the Initial Proposal.[108]

Under the Initial Proposal, AT Persons would be required to retain source code used in their algorithmic trading activities in repositories and make the code available to CFTC Staff upon request. Under the Supplemental Proposal, AT Persons would be required to retain for a period of five (5) years: (i) Algorithmic Trading source code; (ii) records that track changes to Algorithmic Trading source code; and (iii) "log files" that record the activity of the AT Person's Algorithmic Trading system.[109]

> "The *Barclays* opinion has broken down the core pieces of latency arbitrage such as complex order types, proprietary data feeds, and dark pool activity, where high frequency trading firms capitalize."

There has been some debate requiring AT persons to openly share their code and change reports. First, some argue that this infringes on due process property rights since the subpoena process respects the due process rights of property owners by giving them the opportunity to challenge subpoenas for information. Further, some HFT firms use artificial intelligence and machine learning to automatically change their own source code as the artificial intelligence learns from its own trading. Requiring these change reports may be more complicated than simply sharing a repository and log files.[110]

Under the Supplemental Proposal, there would now be three paths to becoming an AT Person. An entity may become an AT Person by: (1) Being registered or required to be registered as an FCM, floor broker, swap dealer, major swap participant, CPO, CTA, or IB that (i) engages in Automated Trading and (ii) satisfies the volume threshold test; (2) Being registered or required to be registered as a "floor trader" by (i) engaging in Algorithmic Trading utilizing DEA and (ii) satisfying the volume threshold test; or (3) Electing to become an AT Person by (i) registering as a floor trader and (ii) complying with related CFTC regulatory requirements.[111]

Reg AT mandates risk controls for the exchanges; clearing members of the exchanges; and firms that trade heavily on the exchanges for their own accounts. Further, the rule proposes requiring the registration of proprietary traders with direct market access. In sum, the goal of Reg AT is to enhance the CFTC's oversight of automated trading activities. [112],[113]

Part VII. National Futures Association (NFA)

1. Fundamental Purpose

Much as the SEC delegated registration to FINRA, the CFTC delegated registration functions to the NFA. The articles of incorporation of the NFA provide for the fundamental purpose of the NFA's existence. Section 1 provides the fundamental purposes of NFA are to promote the improvement of business conditions and the common business interests of persons engaged in commodity futures and swaps or related activity by undertaking the regulation of persons that are members of NFA; relieving the CFTC from the substantial burden of direct regulation in such matters; and providing such regulatory services to such markets as the NFA may from time to time approve.[114]

In the U.S. futures markets, an intermediary is a person or firm who acts on behalf of another person in connection with futures trading. Intermediaries include CPOs, CTAs, IBs, FCMs, APs, Swap Dealers, and Major Swap Participants, which are required to register with the CFTC, a process that it has delegated to the NFA. The same legislation that established the CFTC in 1974 also authorized the creation of registered futures associations, giving the industry the opportunity to create a self-regulatory organization. The CFTC designated the NFA as a registered futures association, and the NFA commenced operations in 1982. Generally, CPOs, CTAs, FCMs, IBs, and SDs must become members of the NFA.[115,116] These parties are subject to general anti-fraud provisions such as rule 180.1 and are policed by the NFA for any fraudulent activity tied to latency arbitrage or HFT activity.

One example of the NFA's involvement in enforcement actions and helping to police its members with the CFTC in regard to HFT is the *Cooper Indus., Ltd. v. Nat'l Union Fire Ins. Co. of Pittsburgh* case. Here, the NFA discovered fraud during a February 2009 audit and suspended the defendant's membership. The defendant was perpetrating a Ponzi scheme. Later that month, the CFTC and the SEC filed an enforcement action in the U.S. District Court for the SDNY. The court appointed a receiver to collect and liquidate any assets, and to determine how to distribute the assets among the victims.[117] Here, by auditing the books of algorithmic traders and latency arbitrators, the NFA was able to assist the CFTC in initiating an enforcement action for fraudulent activity such as spoofing and latency arbitrage.

Part VIII. Conclusion

In conclusion, latency arbitrage is a revolutionary trading strategy that has garnered immense criticism in the United States. The *Barclays* opinion has broken down the core pieces of latency arbitrage such as complex order types, proprietary data feeds, and dark pool activity, where high frequency trading firms capitalize.

The courts are mostly in agreement that exchanges, as self-regulatory organizations, are within their quasi-governmental powers to provide complex order types and proprietary data feeds to their clients and therefore are immune from private causes of action on that basis. As long as exchanges give full disclosure and do not fail to omit material information regarding their co-location services, they will not run afoul of neither SEC Rule 10b-5 or CEA Rule 180.1 provided the co-location services are fair and reasonable and not unreasonably discriminatory.

The securities and commodities laws have adapted to regulation of latency arbitrage by focusing on market fragmentation. In the securities market, Regulation NMS amended the Securities Exchange Act to assure investors receive the best NBBO price. Although there is still concern over front running orders, NMS Rule 603(a) prohibits exchanges from independently transmitting their own data any sooner than they transmit data to a processor in the consolidated tape. Further, the SEC and FINRA have been able to police the flow of market information and 10b-5 fraud with innovative techniques such as MIDAS, consolidated audit trails, elimination of naked access, OATS, TRACE, and smart order routing identification systems.

In the commodities market, the CEA has been able to police all parties involved in commodity transactions by creating a robust infrastructure of member firms and delegating registration authority to the NFA. To help police against violations of CEA Rule 180.1, the CFTC has passed a plethora of regulations, especially after Dodd Frank such as Reg AT, to better police unauthorized latency arbitrage activity.

In sum, low latency systems are evolving, and regulations are effectively policing certain areas such as spoofing and layering but not others such as latency arbitrage. Although individuals can be prosecuted for market manipulation under either SEC Rule 10b-5 or CEA Rule 180.1 for latency arbitrage activity, exchanges should be held liable for the co-location services they provide since they are aiding the front-running of orders.

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29. *See Exchange Act Release No. 34–74032, 2015 WL 137640, at *2*("Order types are the primary means by which market participants communicate their instructions for the handling of their orders to the exchange.")

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Industrial Hemp: U.S. Department of Agriculture Publishes Interim Final Rule To Implement 2018 Farm Bill Program

By Guy P. Lander, Alexander G. Malyshev and Anup Khatri

On October 31, 2019, the U.S. Department of Agriculture (USDA) published its long anticipated interim final rule (the "USDA Rule") implementing the agricultural hemp program under the Agricultural Improvement Act of 2018 (the "2018 Farm Bill").[1] With the enactment of the 2018 Farm Bill in December 2018, hemp was removed from the definition of "marijuana" under the Controlled Substance Act ("CSA").[2] The passage of the bill represented a major step towards establishing a nation-wide market for the hemp industry, but its implementation relied on the USDA to establish and administer a program for lawful hemp production in the U.S.

The USDA Rule, which will enable growers to cultivate hemp as an agricultural commodity in the U.S., outlines the requirements for states and American Indian tribes to develop a hemp production plan for their respective jurisdictions. The USDA Rule also establishes a federal plan for hemp producers in states and tribal territories that do not have their own USDA-approved plan (and have not otherwise opted out of it by outlawing the production of hemp within their jurisdictions).

This is a significant development for the hemp industry and should provide much-needed regulatory guidance, not only to hemp producers, but also to related businesses that, for nearly 11 months since hemp was legalized under federal law, have been operating in a state of uncertainty. The USDA Rule remained open to public comments through December 30, 2019. Its two-year effective period will expire on November 1, 2021, by which time the USDA expects to have replaced it with a final rule that addresses any public comments it receives.

Brief Overview of the USDA Rule

The USDA Rule implements a system of shared federal and state/tribal regulatory oversight of hemp production in the U.S. Under the rule, any person that produces or intends to produce hemp must first be licensed or authorized under the appropriate hemp production plan, which, based on the location of the hemp producer's growing facility, could be either of the following: (1) a USDA-approved state or tribal plan governing the licensing and regulation of hemp production within the jurisdiction (a "State/Tribal Plan") or (2) the USDA-administered federal plan administered by USDA for hemp production in states and tribal territories that do not have their own USDA-approved plan and have not otherwise outlawed hemp production (the "USDA Plan").

Although the USDA Rule separately codifies the substantive requirements under the USDA Plan, and the minimum requirements for State/Tribal Plans, there are similar requirements that all licensed hemp producers must meet irrespective of their governing plan. Those requirements relate generally to various regulatory aspects of hemp production, such as:

- licensing requirements;
- maintaining information on the land on which hemp is produced;
- procedures for testing the THC concentration levels for hemp;
- procedures for disposing of non-compliant plants;
- compliance provisions; and
- procedures for handling violations.

Plan Options under the USDA Rule

State/Tribal Plans

Under the USDA Rule, any state or Indian tribe wishing to maintain primary regulatory authority over hemp production in its jurisdiction can develop and submit, for approval by USDA, a hemp production plan meeting certain minimum requirements. The USDA expressly notes that the USDA Rule does not preempt or limit any state or tribal law that more stringently regulates hemp, but clarifies that states and Indian tribes cannot prohibit or restrict interstate transportation of lawfully-produced hemp through their borders.

The USDA must review and either approve or disapprove of a proposed State/Tribal Plan within 60 days of its submission or it goes into effect. Upon the USDA's approval, hemp producers located within the jurisdiction may apply to the state or tribal government for a license to produce hemp in accordance with the governing plan. Approved State/Tribal Plans remain in effect unless revoked by the USDA pursuant to the revocation procedures outlined in the USDA Rule, or the state or Indian

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tribe substantively revises its plan or its laws to change the plan's ability to meet the requirements of the USDA Rule.

States and Indian tribes that had already submitted or were in the process of developing a hemp production plan prior to the USDA Rule's date of publication must now update their plans, as needed, to conform with the new USDA Rule's requirements.[3]

The USDA's approval of a State/Tribal Plan is conditioned upon that plan meeting certain minimum regulatory requirements, some of which include:

1. *Information on Land Use*: State/Tribal Plans must establish a process for collecting, maintaining and reporting to the USDA information pertaining to the land used for hemp production in the state or tribal territory (e.g., description of the land, hemp crop acreage, etc.).

2. *Sampling and Testing*: State/Tribal Plans must incorporate procedures for sampling and testing cannabis[4] plants to ensure that their THC concentration levels remain below 0.3%. Samples must be physically collected by a federal, state or tribal representative and delivered to a DEA-registered laboratory for testing within 15 days before the anticipated harvest. If the producer fails to complete a harvest within 15 days of sampling, a secondary pre-harvesting sample must be taken and submitted for testing. As a part of the testing process for the THC concentration level of a sample, the laboratory must evaluate and account for the "measurement of uncertainty" (i.e., margin of error in test results) when determining if that sample's THC concentration level exceeds its "acceptable hemp THC level."

3. *Disposal of Non-Compliant Plants*: State/Tribal Plans must include procedures for destroying non-compliant cannabis plants that exceed their "acceptable hemp THC levels" (i.e., 0.3%, plus or minus the measurement of uncertainty), as they would be deemed to be controlled substances under the CSA. Non-compliant plants must be collected and disposed of by a DEA agent or a designated law enforcement officer in accordance with the CSA.

4 *Inspections*: State/Tribal Plans must incorporate procedures for inspecting on an annual basis, at a minimum, a random sample of licensed hemp producers. They must also incorporate procedures to identify and attempt to correct certain negligent acts, such as hemp producers failing to obtain licenses or producing plants exceeding acceptable hemp THC levels.

5. *Information Reporting*: State/Tribal Plans must include procedures for reporting specific information to the USDA, including contact information for all licensed hemp producers, legal descriptions and geospatial locations of the land used for hemp production and the status of each hemp producer's license. States and Indian tribes must report this information to the USDA within 30 days of receipt from the hemp producers.

The USDA Plan

The USDA Rule also establishes a federal plan for hemp producers in states and tribal territories that do not have their own USDA-approved plan and have not otherwise outlawed hemp production. In the absence of a USDA-approved plan, states and Indian tribes will essentially hand over regulatory responsibility to the USDA, and the USDA will provide licenses directly to hemp producers within those jurisdictions.

The USDA was not accepting applications for licenses under the USDA Plan until November 30, 2019, under the rationale that the delay would give states and Indian tribes an opportunity to develop and submit their own plans and minimize instances where the USDA must issue licenses under the USDA Plan to hemp producers in states and tribal territories where the likelihood remains that there will soon be a State/Tribal Plan in place that overtakes the administration of licenses in the jurisdiction.

> "Overall, the USDA Rule serves as a major step forward for the hemp industry."

The requirements under the USDA Plan, which are imposed directly on licensed hemp producers, are largely similar to those under State/Tribal Plans, as also noted above. The USDA Plan does, however, include few differentiating regulations, which are justified by the USDA's ubiquitous role of maintaining a federal licensing system under the USDA Plan in relation to its more limited role of oversight under State/Tribal Plans. Some of those differentiating regulations address approval standards, recordkeeping requirements and procedures for license suspension and revocation.

Considerations Moving Forward

Overall, the USDA Rule serves as a major step forward for the hemp industry. It clears up a significant amount of regulatory ambiguity that has plagued hemp producers and related businesses for nearly a year. One does not need to look further than the case of *Big Sky Scientific LLC v. Idaho State Police*, Case No. 19-CV-00040 (D. Idaho), where a shipment of hemp was seized in Idaho, which does not distinguish between hemp and marijuana, and which took the position that the hemp was not cultivated in accordance with the 2018 Farm Bill because no plans have been approved (and as a result the preemption provisions did not apply). The USDA previously noted its disagreement with how that case has proceeded.[5]

The USDA Rule will contribute to the further expansion of lawful hemp production in the U.S. However, the regulatory framework established under the USDA Rule appears to be rather complex, and as a result, may require a considerable amount of time for the various industry participants to understand some of its implications. In light of this, the USDA has encouraged states and Indian tribes to work with the USDA to obtain technical assistance in developing the specifics of their plans. The USDA has also made available informational tools and resources to help guide individuals through the regulations, including a recorded webinar that the USDA released one week after publication, which goes over key elements of the USDA Rule, including a timeline for implementation and information about testing requirements.[6]

The USDA has acknowledged that the USDA Rule is not perfect and that uncertainties remain. However, the USDA appears confident that these issues can be adequately addressed and resolved through its continuing analysis of the regulations and their practical implications, as well as the industry's feedback on any concerns and potential solutions to those concerns.

Endnotes

1. *See* "USDA Establishes Domestic Hemp Production Program," USDA Press Release (October 29, 2019), available at https://www.usda.gov/media/press-releases/2019/10/29/usda-establishes-domestic-hemp-production-program.
2. The USDA Rule reiterates the 2018 Farm Bill's definition of hemp as "the plant species Cannabis sativa L. and any part of that plant, including the seeds thereof and all derivatives, extracts, cannabinoids, isomers, acids, salts, and salts of isomers, whether growing or not, with a delta-9 tetrahyrdrocannabinol (THC) concentration of not more than 0.3 percent on a dry weight basis." In other words, any cannabis plant or product that contains more than 0.3 percent THC will still be considered marijuana, a Schedule I drug that is illegal under federal law.
3. Prior to the USDA Rule's publication, 10 states and 10 Indian tribes had already submitted hemp production plans for USDA approval. Since its publication and as of November 7, 2019, only one state and one Indian tribe had submitted plans. https://www.ams.usda.gov/rules-regulations/hemp/state-and-tribal-plan-review.
4. Cannabis is a plant belonging to the Cannabaceae family and containing a variety of biologically active chemical compounds. Hemp and marijuana are both varieties of cannabis, though "cannabis" is often used interchangeably with "marijuana." The distinction between hemp and marijuana is the concentration of THC, a psychoactive compound. Hemp (sometimes referred to as "industrial hemp") contains no more than 0.3% THC on a dry weight basis, while marijuana contains a greater concentration of THC.
5. See "Legal Opinion on Certain Provisions of the Agriculture Improvement Act of 2018 Relating to Hemp," USDA Memorandum (May 28, 2019) discussing Big Sky Scientific in a section titled "Recent Developments." Available at https://www.ams.usda.gov/sites/default/files/HempExecSumandLegalOpinion.pdf.
6. https://zoom.us/recording/play/TAEflEP96bk0nvHTbp6JVKoR4JX4O2hXFaCZAdXjDhow NT2F6SDhHmGDAqCCv9nB.

How New York Can Be a Center for International Franchising

By Thomas M. Pitegoff

New York prides itself on being an international hub of trade, finance, culture and diplomacy. Lawyers know that New York is also an important venue for the resolution of international disputes. Since 1984, New York has specifically promoted designating New York law as the governing law in international contracts and New York courts as the forum for the resolution of international disputes.[1] The New York State Bar Association endorsed the choice of New York law and forum in its 2011 Task Force report on New York Law in International Matters.[2]

By contrast, New York's franchise law discourages international franchising in New York. In both outbound and inbound international franchising, the New York Franchise Sales Act (NYFSA)[3] impedes international business in the state.

The NYFSA was enacted in 1981 and has never been amended. But with just two changes in the law, New York can break through this impediment and become a magnet for international franchising.

- Outbound transactions: Make it clear that the NYFSA does not apply when a franchisor in New York enters into one or more agreements granting to franchise buyers abroad the right to own and operate franchises to be located exclusively outside of the United States.
- Inbound transactions: Allow a franchisor outside the United States to grant master franchise rights in the U.S. to a single New York business to sell franchises without requiring the franchisor outside the United States to prepare detailed franchise disclosures or to register the single franchise offering to a U.S. master franchisee.

Under current New York law, both outbound and inbound international franchise sales require compliance with extensive registration and disclosure requirements.

These changes in New York law need not strip the Department of Law, also known as the Attorney General's Office, from jurisdiction over outbound and inbound international transactions through the anti-fraud provisions under the NYFSA.[4]

Just to clarify, in an inbound transaction where a foreign franchisor grants master franchise rights to a single New York person, the foreign franchisor would not be required to prepare a detailed franchise disclosure document and register as a franchisor with the New York Attorney General's Office. However, the New York master franchisee would be required to comply with the U.S. federal and state registration and disclosure requirements, which may include disclosures about the foreign franchisor.

A change in the NYFSA to relieve the foreign franchisor from the obligation of preparing an FDD and registering the offering for the single agreement would go a long way toward facilitating international franchising in New York. It would allow the foreign franchisor and the New York franchisee to move quickly to negotiate and sign the master franchise agreement.

Franchise Law Background

The sale of franchises in the U.S. is regulated by federal and state laws. The Federal Trade Commission (FTC), through its trade regulation rule on franchising (FTC Rule),[5] requires franchisors throughout the U.S. to make detailed written disclosures to each franchise buyer before the buyer signs the franchise agreement or makes any payment to the franchisor. These disclosures must be in the prescribed format called a "franchise disclosure document" or FDD.

New York also requires franchisors to prepare an FDD and deliver it to franchise buyers before they purchase the franchise. New York and several other states[6] also require franchisors to register their franchise offerings before they can sell franchises in the state. In New York, franchisors register their franchise offerings with the Attorney General's Office.

Preparation of the FDD is a detailed and time-consuming process. Among other things, the FDD must include the franchisor's audited financial statements. Franchise registration in New York entails the Department of Law's review of the FDD for compliance and possible revisions. This review process commonly takes weeks to complete, following weeks spent preparing the FDD.

Selling Franchises Abroad

The NYFSA appears to apply to a New York franchisor's franchise sales abroad, unlike the FTC Rule and unlike any other state franchise sales law. Whether a New York franchisor is granting a franchise for a single unit in Canada or development rights for the entire European Union or all of China, the franchise offering must be registered in New York.

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Following its text, the NYFSA applies when a person offers to sell or sells a franchise in New York.[7] A person offers to sell or sells a franchise in New York when

> an offer to sell is made in this state, or an offer to buy is accepted in this state, or if the franchisee is domiciled in this state, the franchised business is or will be operated in this state.

An offer to sell is made in New York

> when the offer either originated from this state or is directed by the offeror to this state and is received at the place to which it is directed. An offer to sell is accepted in this state when acceptance is communicated to the offeror from this state.[8]

There appears to be no limit on the international application of the NYFSA. As long as the offer originates from New York or the acceptance is communicated from New York, the law may apply, even if the franchisee is located abroad.

"A change in the NYFSA to relieve the foreign franchisor from the obligation of preparing an FDD and registering the offering for the single agreement would go a long way toward facilitating international franchising in New York."

The courts have long upheld the constitutionality of the extraterritorial reach of the NYFSA. At least one court has held that the broad extraterritorial reach of the NYFSA does not impose an impermissible burden on interstate commerce.[9]

No other state requires a U.S. franchisor to register in order to sell franchises to out-of-state residents for franchises to be located outside the state, let alone anywhere outside the U.S.[10]

Federal law also does not regulate the sale of franchises abroad. The FTC Rule refers to the offer or sale of a franchise "to be located in the United States of America or its territories."[11] Foreign franchise purchasers are likely to be sophisticated companies represented by counsel. Countries differ in markets, cultures and legal systems. Because offerings in different countries are likely to differ, the FTC noted in its Statement of Basis and Purpose[12] that, if the FTC Rule were to apply to franchises located outside the U.S.,

> a franchisor arguably would have to prepare individual disclosure documents tailored to each specific foreign market. Not only would such a requirement put American franchisors at a competitive disadvantage with franchisors from countries lacking comparable disclosure regulations, but it is likely that any possible benefits of such a requirement would not outweigh the extraordinary costs and burdens involved.

Inbound Franchising

Inbound franchising from a foreign franchisor to a U.S. master franchisee in New York is also problematic. Appointing a master franchisee in New York clearly requires registration and disclosure under the NYFSA unless an exemption applies. A company outside the U.S. that wants to grant master franchise rights to a single master franchisee located in New York must register that offering with the state and must provide the required disclosures to the single prospective master franchisee.

The NYFSA does exempt the sale of a single franchise.[13] But this exemption only applies if the franchisor does not grant the franchisee the right to offer subfranchises to others. Because a master franchise necessarily includes the right to grant subfranchises, this single-sale exemption does not apply to the grant of master franchise rights.

Master franchising is a common approach to international franchising. In international master franchising, the franchisor in one country grants to a company in the destination country the right to sell franchises and to manage the franchise system in the destination country. Master franchising in the U.S. is most commonly used in outbound franchising into other countries.

Master franchising is less common in inbound international franchising. One reason for this is that the foreign franchisor may need to prepare a disclosure document and register before granting the single master franchise agreement, whether in New York or in another state that requires franchise registration. At the federal level, on the other hand, the grant of a single master franchise for the entire U.S. may arguably fall within the scope of the single trademark license exclusion under the FTC Rule.[14]

A second reason that master franchising into the U.S. is not common is that both the U.S. master franchisee and the foreign franchisor would be required to disclose to the master franchisee's buyers in the U.S. in one FDD, with each being responsible for the other's compliance with the disclosure requirements.[15] The FDD would need to include the audited financials of both the foreign franchisor and the U.S. master franchisee. This is especially difficult when the master franchisor is not a U.S. company.

For this reason, it often makes sense for a foreign franchise company to form a subsidiary in the U.S. to sell franchises, whether that subsidiary is wholly owned or a joint venture with a U.S. partner. But some companies are not ready to set up their own operation in the U.S. And in some cases, such as franchising from Canada, direct unit franchise agreements into the U.S. might be the best approach, with the foreign franchisor fully complying with U.S. registration and disclosure requirements. The foreign franchisor might even set up a wholly owned company in New York to be the franchisor while managing the operation from its offices abroad, with an entirely offshore set of officers and directors.

Discretionary Exemption in N.Y.

The NYFSA does offer a way to escape its own impediments to international franchising. New York allows franchisors to seek a "discretionary exemption" from the registration and disclosure requirements. The Department of Law may grant a discretionary exemption "if the department finds that such action is not inconsistent with the public interest or the protection of prospective franchisees."[16]

Requests for discretionary exemption are made by letter addressed to the New York Department of Law explaining the facts and the basis for the request. The applicant's attorney must also file a Notice of Appearance and pay a small fee. The current assistant attorney general in charge of franchising in the Investor Protection Bureau has said that he commonly grants discretionary exemptions for the sale of franchises outside the U.S. But relying on the policy of a particular assistant attorney general is not the ideal way to handle this issue. We have no way of knowing whether his successor will be so generous in granting discretionary exemptions for international franchise sales. It would be far better to change the law to make it clear that there is no need for this burdensome requirement in New York.

Change New York Law

One approach to correcting both the outbound and inbound international impediments to franchising in New York law and promoting New York as a base for international franchising would be to add a new Section 684.7 to the N.Y. General Obligations Law which might read as follows:

> The offer or sale of a franchise shall be exempted from the registration and disclosure requirements of Section 683 of this Article if:
>
> (a) The offer or sale is directed to any number of persons for the right to operate one or more franchises to be located outside of the United States; or
>
> (b) The franchisor is domiciled outside of the United States and the franchisor grants to a single person in this state the right to own and operate one or more franchises and to grant subfranchises.

A better way to handle the outbound franchise sales issue would be take the approach of every other state that requires franchise registration by exempting franchise sales where the buyer is a resident of another state or country. [17] In other words, any franchise sale outside of New York would be exempt, whether the franchise buyer is located in another U.S. state or abroad.

The law might also go one step further and provide that the offer to the out-of-state buyer must not violate federal law or the law of the foreign jurisdiction where the franchise business will operate or where the franchisee is domiciled. [18] In addition, this change in New York law need not relieve the New York franchisor of the requirement to comply with the anti-fraud provisions of the NYFSA.[19]

A number of other changes in the NYFSA would make New York even more appealing as a center for franchising generally.[20] The most important of these changes would be to revise the overly-broad definition of a franchise under the NYFSA to conform to the definition of a franchise used in other states. Another important change would be to revise the waiting period between disclosure and contract signing, requiring 14 calendar days instead of 10 business days and eliminating the requirement to deliver the FDD at the "first personal meeting" with the prospective franchisee.

These changes are important. They would bring New York franchise law more into line with the franchise laws of other states and encourage more franchise companies to set up their operations in New York. A new exemption for inbound international franchise transactions in particular, would set New York apart from other states that require franchise registration and might attract more franchisors abroad to launch their U.S. franchise operations from New York.

Endnotes

1. N.Y. General Obligations Law (GOL) Title 14, Sections 5-1401-5-1402.
2. Task Force on New York Law in International Matters, https://nysba.org/NYSBA/Sections/Dispute%20Resolution/Dispute%20Resolution%20PDFs/Task%20Force%20on%20New%20York%20Law%20in%20International%20Matters.pdf.
3. N.Y. General Business Law (GBL) Article 33, Sections 680-695.
4. N.Y. Gen. Bus Law § 687.
5. 16 CFR Part 436.

6. These states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, North Dakota, Rhode Island, South Dakota, Virginia, Washington, Wisconsin.
7. N.Y. Gen. Bus. Law § 683(1).
8. N.Y. Gen. Bus. Law §§ 681(12)(a) and (b). *See A Love of Food I v. Maoz Vegetarian USA, Inc.*, Bus. Franchise Guide (CCH) ¶14,684 (D. Md. 2011).
9. *Mon-Shore Management, Inc. v. Family Media, Inc.*, 584 F.Supp. 186 (SDNY 1984).
10. For example, the California Franchise Investment Law provides as follows in Cal. Corp. Code § 31105:"Any offer, sale, or other transfer of a franchise, or any interest in a franchise, to a resident of another state or any territory or foreign country, shall be exempted from the provisions of Chapter 2 (commencing with Section 31110) of this part [the registration and disclosure requirements], if all locations from which sales, leases or other transactions between the franchised business and its customers are made, or goods or services are distributed, are physically located outside this state."
11. 16 C.F.R §436.2.
12. Statement of Basis and Purpose, 72 Fed. Reg. 15,445 (Mar. 30, 2007) at page 15,468 (text accompanying footnote 248.)
13. NY GBL §684(3)(c).
14. The FTC Rule excludes the grant of the right to use a trademark where the license is the only one of its general nature and type to be granted by the licensor with respect to the trademark. This exclusion is one of four non-franchise relationships that appeared as specific exclusions in the 1970 franchise rule at 16 CFR 436.2(a)(4)(i)-(iv). These exclusions are retained in the revised FTC Rule as a matter of policy, although the specific text of the exclusions was removed from the final Rule as part of the FTC's effort to streamline the Rule. See notes 67, 777 and 871 of the Statement of Basis and Purpose and the accompanying text. 72 Fed. Reg. 15,544 (March 30, 2007).
15. See the FTC's Franchise Rule Compliance Guide, p. 17 (May 2008).
16. N.Y. Gen. Bus. Law § 684(1).
17. *See supra* note 6. *See also* Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Laws, American Bar Association, 2017.
18. As in the franchise laws of Rhode Island, South Dakota and Wisconsin. In Rhode Island, an offer or sale of a franchise is exempt if

    > (1) It is offered or sold to a nonresident of this state; (2) the franchise business will not be operated wholly or partly in this state; (3) the offer or sale does not violate federal law or the law of the foreign jurisdiction; and (4) the offeree is not actually present in this state during any offer or sale. R.I. Gen. Laws § 19-28.1-7.

    In South Dakota, an offer or sale of a franchise is exempt if

    > the offer or sale is made to a person not a resident of this state, if the franchise will not be located in this state, and if the offer or sale does not constitute a violation of the laws of the state or foreign jurisdiction in which the offeree or purchaser is present and is not part of an unlawful attempt to evade this chapter. S.D. Codified Laws § 37-5B-3.

    In Wisconsin, an offer or sale of a franchise is exempt

    > where the franchisee or prospective franchisee is not domiciled in this state and where the franchise business will not be operated in this state, and provided that the offer, sale and purchase of the franchise is effected in compliance with any applicable franchise law of the state in which the franchise business will be operated or the franchisee is domiciled. Wis. Admin. Code DFI § 32.05(1)(d).
19. *See supra* note 4.
20. See Thomas M. Pitegoff, *Franchising in New York After the Revised FTC Rule*, N.Y. Business Law Journal, Fall 2007, Vol. 11, No. 2. The NYSBA's Business Law Section proposed sweeping changes to the NYFSA in a report dated November 10, 2009. The Executive Committee of the NYSBA endorsed these changes in January 2010. But these changes have not been enacted into law.

Inside the Courts: An Update from Skadden Securities Litigators

By the Attorneys at Skadden, Arps, Slate, Meagher & Flom LLP

This issue includes summaries and associated court opinions of selected cases principally decided between October 2019 and January 2020.

Collateral Estoppel

D. Mass. Grants Summary Judgment in Civil Case Against Investment Adviser Who Pleaded Guilty to Similar Criminal Convictions

SEC v. Cody, No. 16-cv-12510 (D. Mass. Dec. 5, 2019)

Judge F. Dennis Saylor IV granted summary judgment on claims of violations of Section 206 of the Investment Advisers Act and Section 10(b) of the Securities Exchange Act brought by the Securities and Exchange Commission against an investment adviser who was also a broker representative. The government alleged that the investment adviser hid significant account losses from clients by lying and creating false documents concerning their accounts. The government also alleged that the investment adviser failed to disclose to his clients that he had been suspended from associating with any FINRA member firm. The investment adviser was later charged in a criminal case for committing fraud under the Investment Advisers Act. The investment adviser pleaded guilty to those criminal charges, and the SEC moved for summary judgment, arguing that the investment adviser was collaterally estopped from contesting the SEC charges because he pleaded and was found guilty to similar criminal convictions.

The court determined that what the investment adviser pleaded guilty to—a willful violation of Section 206(2) —has "nearly identical" "necessary elements for civil liability under § 206(2)." The court noted that the *mens rea* requirements for criminal liability and civil liability were not the same but reasoned that "acting with scienter or a willful state of mind satisfie[d] the lesser requirement of a negligent state of mind." The court also found that the investment adviser's guilty plea "preclude[d] him from contesting the SEC's claim under § 10(b) and Rule 10b-5(c) of the Exchange Act." In addition, the undisputed evidence showed that the investment adviser bought and sold securities in the accounts of certain victims, and his "fraudulent acts were employed in connection with the purchase or sale of a security" and therefore that element was met.

D. Mass. Grants Summary Judgment Against CEO and Finds Two Companies Liable for the CEO's Conduct

SEC v. Muraca, No. 17-cv-11400 (D. Mass. Dec. 5, 2019)

Judge F. Dennis Saylor IV granted summary judgment on claims of violations of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act brought by the Securities and Exchange Commission against a CEO and the two biotechnology companies he founded. The SEC alleged that the CEO "raised investor funds and then diverted a substantial portion for his personal use." The CEO was previously indicted for federal wire fraud and making a false statement to the FBI. The SEC moved for summary judgment, arguing issue preclusion, and one of the companies cross-moved for summary judgment, arguing that it should not be held liable for the CEO's actions.

The court granted the SEC's motion and denied the company's motion, holding that the CEO was precluded from contesting the SEC's claims against him because he had already been convicted of similar criminal claims. The court reasoned that the CEO's wire-fraud conviction "required the jury to find all of the elements that are necessary to support civil liability under § 17(a), § 10(b) and Rule 10b-5; that he made a material misrepresentation, with scienter, in connection with the purchase or sale of securities." The court noted that the "factual allegations underlying [the CEO's] criminal conviction are nearly identical to those underlying the civil allegations," and therefore found him precluded from contesting the SEC's claims. The court determined that the SEC was not judicially estopped from arguing issue preclusion concerning the CEO's criminal conviction, rejecting the company's argument that because the government (i.e., the Department of Justice) in the criminal conviction portrayed the company as a victim of the CEO's crimes, the government (i.e., the SEC) could not now argue the opposite. The court

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found that because the DOJ and the SEC are separate parties their positions were not contrary.

The court also determined that the CEO's conduct was imputable to the companies, rejecting the argument that the CEO was not acting within the scope of his employment or on behalf of the company when he diverted funds for his own use. The court reasoned, for example, that when the CEO raised more than $1 million of investor funds (which he subsequently used for his personal benefit) he was acting on behalf of the company as he told investors their funds were for the companies.

Fiduciary Duties

Annual Meetings and Corporate Elections

Delaware Supreme Court Reverses Court of Chancery, Enforcing 'Clear and Unambiguous' Language in Advance-Notice Bylaws

BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd., No. 297, 2019 (Del. Jan. 13, 2020)

The Delaware Supreme Court reversed the Court of Chancery's issuance of a mandatory injunction prohibiting two trusts from deeming a stockholder's nominations to the board ineligible because the stockholder failed to respond to the trusts' request for additional information within the five-business-day time period expressly stated in the trusts' bylaws.[1]

Saba Capital Master Fund, Ltd., a stockholder of two BlackRock-affiliated trusts, delivered a timely "nomination notice" to each of the two trusts to nominate four individuals to their respective boards. The bylaws of each trust provided that a stockholder giving notice of a nomination "shall further update and supplement such notice, if necessary, so that: . . . any subsequent information reasonably requested by the Board of Directors [of the trust] to determine that the Proposed Nominee has met the director qualifications as set out in Section 1 of Article II is provided, and such update and supplement shall be delivered to or be mailed and received by the Secretary at the principal executive offices of the Fund no later than five (5) business days after the request by the Board of Directors for subsequent information regarding director qualifications has been delivered to or mailed and received by such shareholder of record."

The trusts' counsel emailed Saba a request for additional information, attaching a questionnaire. When Saba did not respond within five business days, the trusts' counsel emailed Saba stating that the nomination notices were invalid. Saba filed suit in the Delaware Court of Chancery seeking an injunction ordering that its nominees not be precluded.

In the case below, the Court of Chancery found that the bylaw provisions were adopted on a "clear day" and were clear and unambiguous. However, the Court of Chancery found that the trusts "went too far" and breached the bylaws because the questionnaire exceeded the scope of the information that the trusts could request under the relevant provision of the bylaws. The Court of Chancery issued a mandatory injunction prohibiting the trusts from invalidating Saba's nominees.

On appeal, the Delaware Supreme Court reversed, holding that "under the clear language of the Bylaws, Saba had an obligation to respond to the request before the expiration of the [five-business-day] deadline," and there was nothing in the record to suggest that the "over-breadth" of the questionnaire precluded a timely response. The Delaware Supreme Court explained that if stockholders could simply ignore deadlines and then raise belated objections, it "would create uncertainty in the electoral setting" and "potentially frustrate the purpose of advance notice bylaws."

> "The Delaware Supreme Court explained that if stockholders could simply ignore deadlines and then raise belated objections, it 'would create uncertainty in the electoral setting . . . ' "

Books and Records

Court of Chancery Limits Production of Books and Records to 'Formal Board Materials'

Lebanon Cnty. Emps.' Ret. Fund v. AmerisourceBergen Corp., No. 2019-0527-JTL (Del. Ch. Jan. 13, 2020)

Vice Chancellor J. Travis Laster ordered the production of books and records sought for the "well-established" purpose of investigating wrongdoing or mismanagement by the company's directors and officers, but limited the scope of production to "formal board materials."

The plaintiffs' books and records demand, brought pursuant to Section 220 of the Delaware General Corporation Law, followed "the flood of government investigations and lawsuits" related to the company's role in the opioid crisis. In holding that the plaintiffs had established a credible basis to support their demand, the court explained that "[o]ngoing investigations and lawsuits can provide the necessary evidentiary basis to suspect wrongdoing or mismanagement warranting further investigation." In addition, the court rejected the company's argument that the plaintiffs' purpose was confined to investigating claims "with the sole objective of bringing litigation," explaining that under Section 220, "a stockholder need not both articulate a proper purpose" and "commit in advance to the ends to which it will put the books and records."

The Court of Chancery limited the scope of production pursuant to a Section 220 demand to "formal board materials" concerning, among other things, the company's opioid distribution. The court explained that "board-level documents that formally evidence the directors' deliberations" are "[t]he starting point (and often the ending point) for an adequate inspection" under Section 220, and that a plaintiff must first make a "proper showing" to access informal board materials such as "emails and other types of communication sent among the directors themselves." The court found that the stockholder-plaintiffs did not make such a showing, and therefore were not entitled to informal board materials. However, noting that the company had refused to provide information about "what types of books and records exist, how they are maintained, and who has them," the court permitted the plaintiffs to take limited discovery into how the company maintained its books and records. The Court of Chancery subsequently certified an interlocutory appeal of the court's rejection of the purpose-plus-an-end test, rejection of the actionable wrongdoing requirement and grant of leave to take discovery.

Derivative Litigation

Court of Chancery Grants Derivative Plaintiff Access to Documents Relied Upon by Special Litigation Committee

In re Oracle Corp. Derivative Litig., No. 2017-0337-SG (Del. Ch. Dec. 4, 2019)

Vice Chancellor Sam Glasscock III held that a derivative plaintiff could access documents a special litigation committee reviewed and relied upon when determining that the derivative action should be pursued by the lead plaintiff.

The lead plaintiff brought derivative litigation challenging the acquisition of NetSuite Inc. by Oracle Corporation.[2] After the case withstood a motion to dismiss, Oracle formed a special litigation committee (SLC) to evaluate the derivative claims. The SLC conducted an investigation and determined that it was in the corporate interest for the litigation to be prosecuted by the lead plaintiff.

The Court of Chancery held that the SLC's evaluation and investigation of the derivative claims enhanced the litigation asset and that documents relied on by the SLC pertained to the asset and must be available to the lead plaintiff, "subject to the privileges and immunities that may be raised by the individual Defendants and the special litigation committee in its business judgement." Specifically, the Court of Chancery held that the lead plaintiff was "presumptively entitled to the production of all documents and communications actually reviewed and relied upon by the SLC or its counsel in forming its conclusions that (i) it would not be in Oracle's best interests to seek to dismiss the derivative claims and (ii) it was in Oracle's best interests to allow the Lead Plaintiff (rather than the SLC) to proceed with the litigation on behalf of Oracle."

The Court of Chancery noted that "disclosure of even a part of the contents of a privileged communication surrenders" any claim to attorney-client privilege for that communication. As a result, the lead plaintiff could obtain access to Oracle's privileged communications that were reviewed and relied upon by the SLC to the extent that those communications were not redacted for attorney-client privilege when produced to the SLC.

Court of Chancery Dismisses Derivative Claims for Failure to Plead Demand Futility

In re LendingClub Corp. Derivative Litig., Consol. C.A. No. 12984-VCM (Del. Ch. Oct. 31, 2019)

Vice Chancellor Kathaleen St. J. McCormick granted a motion to dismiss breach of fiduciary duty claims against directors arising out of alleged oversight failures.

The plaintiffs, stockholders of LendingClub Corp., alleged that, following whistleblower allegations and an internal investigation, LendingClub self-reported issues relating to the sale of nonconforming loans, related party transactions and accounting practices to the SEC, which led to an SEC investigation. After corrective disclosures were issued, stockholders brought federal securities claims in the Northern District of California and derivative breach of fiduciary duty claims in the Delaware Court of Chancery.

The plaintiffs in the Delaware action alleged that demand was futile because a majority of the board faced a substantial likelihood of liability by failing to implement and monitor internal controls. Among other arguments, the court rejected the plaintiffs' theory that the board "utterly fail[ed]" to implement a reasonable compliance system, noting that "[t]he factual allegations in the Complaint indicate that LendingClub's Audit Committee both (1) existed, and (2) met monthly." The court also held that the plaintiffs failed to plead sufficient facts showing that the board ignored red flags with respect to the related party transactions, sale of nonconforming loans and accounting issues. In doing so, the court noted that the board took "remedial action immediately" after learning about these problems, and that although "actions taken after the fact do not absolve past transgressions," the pleaded facts demonstrated that "the Board implemented an oversight system and, when the Board first learned that it was not working, created a new one."

The Court of Chancery also addressed the plaintiffs' allegations that the board lacked independence from one of the directors who benefited from the related party transactions. The plaintiffs argued that one of the directors lacked independence because he "shared a 'thirteen-year working relationship'" with the alleged wrongdoer while they both worked for an investment bank. The court held that this argument failed to show a lack of independence because the plaintiffs failed to plead that the two individuals "worked in the same office, held positions that required them to work together, or otherwise knew each other while working" for their former employer. The court rejected another argument that two directors could not be "considered independent because they served on the same board." Finally, the court rejected the argument that "the *entire* Demand Board somehow lacked independence" from the alleged wrongdoer because the other directors did not exclude him from deliberations, terminate him or require him to divest his interests in a company benefited from the related party transactions.

"In discussing the letter, the Court of Chancery called the plaintiff's approach the 'Magritte defense,' referencing a painting depicting a pipe, but stating, 'This is not a pipe.'"

Court of Chancery Finds That Presuit Communication Is Rule 23.1 Demand

Solak v. Welch, No. 2018-0810-KSJM (Del. Ch. Oct. 30, 2019); *Dahle v. Pope*, No. 2019-0136-SG (Del. Ch. Jan. 31, 2020)

Vice Chancellor Kathaleen St. J. McCormick of the Delaware Court of Chancery dismissed derivative claims challenging a company's nonemployee director compensation, holding that a presuit letter was a "demand" for purposes of Court of Chancery Rule 23.1.

In *Solak v. Welch*, the plaintiff sent a presuit letter requesting that the company's board of directors take remedial action to address allegedly excessive nonemployee director compensation (the "Demand").[3] The Demand contained a footnote stating "[N]othing contained herein shall be construed as a pre-suit litigation demand under Delaware Chancery Rule 23.1." In discussing the letter, the Court of Chancery called the plaintiff's approach the "Magritte defense," referencing a painting depicting a pipe, but stating, "This is not a pipe." In response to the Demand, the board conducted an investigation and resolved to reject the Demand.

The court held that the Demand satisfied the definition of a "demand" under Delaware law because "although the Letter avoid[ed] expressly demanding that the Board commence litigation, the Letter clearly articulate[d] the need for 'immediate remedial measures,' propose[d] remedial action, and request[ed] that the Board take such action." In addition, the court observed that the complaint was "nearly a carbon copy" of the Demand and that the Demand requested remedial measures benefiting the company as a whole and "resemble[d] therapeutic benefits commonly achieved in derivative lawsuits challenging non-employee director compensation."

In rejecting the plaintiff's "Magritte defense," the Court of Chancery explained that Delaware law's prohibition on a stockholder both making a demand and pleading demand futility "would become a virtual nullity if a stockholder could avoid a judicial determination that pre-suit demand was made by simply stating 'this is not a demand' in his pre-suit communication."

After finding that the plaintiff had made a demand, the Court of Chancery held that the plaintiff failed to allege any facts supporting an inference that the board wrongfully rejected the Demand, warranting dismissal of the action.

In *Dahle v. Pope*, the same plaintiffs' counsel sent a "near identical" demand letter to another corporate board and raised an "identical defense" to dismissal.[4] Vice Chancellor Sam Glasscock III adopted the "well-reasoned analysis" of *Solak v. Welch* and granted the defendants' motion to dismiss because the plaintiffs made a demand and failed to allege wrongful refusal of that demand.

Middle District of Tennessee Dismisses Derivative Litigation for Failure To Make a Demand

In re Tivity Health, Inc., No. 3:18-CV-00087 (M.D. Tenn. Oct. 21, 2019)

Judge Waverly D. Crenshaw Jr. granted a motion to dismiss a derivative action brought by two shareholders of a health services company. The company, Tivity Health, operates as a fitness program broker. Tivity enters into contracts with fitness centers, offering access to members of select health insurance plans. Insurers pay Tivity a fee for this service. One of Tivity's largest customers was UHC, contributing $94.6 million in revenue to Tivity in 2017. On November 6, 2017, UHC announced that it would offer its own fitness benefit program, becoming

Tivity's competitor. That same day, Tivity's stock dropped by 34%.

The plaintiffs sued the company, as well as its directors, bringing claims of securities fraud and breach of fiduciary duty. The plaintiffs alleged that the defendants approved and permitted disclosures that misrepresented the sustainability of Tivity's revenue stream. In response, the defendants filed a motion to dismiss, alleging that the plaintiffs lacked standing and did not meet the demand requirement for a derivative suit.

The defendants claimed that the plaintiffs lacked standing because they did not own Tivity stock at the time of the alleged misrepresentations. Federal Rule of Civil Procedure 23.1 requires that plaintiffs have an ownership interest in the company at the time of the conduct at issue. The plaintiffs became Tivity shareholders in June 2017, but their complaint alleged that misrepresentations started in February 2017, and continued until October 2017. The plaintiffs argued that the defendants engaged in "continued wrongdoing," giving the plaintiffs standing to challenge statements made even before June 2017. Specifically, the plaintiffs alleged that Tivity began to flaunt its close relationship with UHC and never let on that UHC was becoming a direct competitor. The first time Tivity admitted it was misrepresenting its relationship with UHC was, the plaintiffs alleged, when UHC announced its own plan, five months after the plaintiffs became Tivity shareholders. The court agreed, holding that the plaintiffs sufficiently alleged that the conduct was so intertwined that there was only one continuing wrong.

The defendants next argued that the plaintiffs' claim should be dismissed because the plaintiffs did not present a demand to Tivity's board of directors, nor did they meet the requirements for demand futility. To establish demand futility, the plaintiffs must allege facts establishing that the directors could not have viewed a demand in a disinterested manner. Delaware law provides that the interestedness of a board is a fact-based analysis specific to each director of the board. Here, the plaintiffs alleged facts sufficient to prove the interestedness of two of Tivity's directors, but not for the other seven. Instead, the plaintiffs alleged that the directors would have collectively been interested because they knew, but failed to disclose, that revenues would plummet when they lost their contract with UHC. The court disagreed, citing evidence from June and October 2017 board meetings projecting both membership and revenue growth. The court held that the plaintiffs could not allege the interestedness of the board at large, as the directors had reason to believe that revenue would continue to grow. Accordingly, the plaintiffs' derivative suit was dismissed for failure to make a demand.

Merger Litigation

Court of Chancery Dismisses Breach of Fiduciary Duty and Aiding-and-Abetting Claims

In re Essendant, Inc. Stockholder Litig., Consol. C.A. No. 2018-0789-JRS (Del. Ch. Dec. 30, 2019)

Vice Chancellor Joseph R. Slights III dismissed breach of fiduciary duty and aiding-and-abetting claims arising from Essendant Inc.'s merger with Staples, Inc.[5]

Prior to the merger with Staples, Essendant and Genuine Parts Company had entered into a stock-for-stock merger agreement. Shortly after the announcement of the Genuine Parts merger, Sycamore Partners, Staples' parent company, delivered an all-cash offer of $11.50 per share to acquire Essendant. The Essendant board rejected this offer. Sycamore ultimately increased its offer to $12.80 per share. Essendant then terminated the Genuine Parts transaction and agreed to a transaction with Sycamore.

Certain Essendant stockholders filed suit alleging, among other things, that (i) the Essendant board breached its fiduciary duties when agreeing to the Sycamore all-cash offer, (ii) Sycamore breached its fiduciary duties as a controller of Essendant, (iii) the Essendant board aided and abetted Sycamore's breaches of fiduciary duty, (iv) Sycamore and Staples aided and abetted the Essendant board's breaches of fiduciary duties, (v) the Essendant board committed waste in agreeing to a $12 million termination fee in the Genuine Parts merger agreement, and (vi) Essendant's CEO breached his fiduciary duties as an officer of Essendant.

In holding that the plaintiffs failed to plead that Sycamore was Essendant's controlling stockholder, the court observed that "Sycamore did not (i) nominate any members of the Essendant Board, (ii) wield coercive contractual rights, (iii) maintain personal relationships with any of the Essendant Board members, (iv) maintain any commercial relationships with Essendant that would afford leverage in its negotiations, (v) threaten removal, challenge or retaliate against any of the Essendant Board members or (vi) otherwise exercise 'outsized influence' in Essendant's Board room."

The Court of Chancery rejected the plaintiffs' argument that the Essendant board engaged in bad faith, finding that merely alleging that the Essendant board took a lower all-cash offer was not enough to state a claim. The court stated that the decision to choose "a cash transaction with Sycamore rather than a stock deal with [Genuine Parts]" was "a judgment call well within a board's prerogative when pursuing the 'highest value reasonably available to the [Essendant] shareholders.'"

The court also rejected the plaintiffs' disclosure claims, holding that the plaintiffs failed to plead sufficient facts to "allow any inferential explanation of why these fiduciaries would so abandon their duties as to engage in bad faith" in connection with the disclosures.

In addition, in addressing the plaintiffs' claim against Essendant's CEO, the court found that the only officer-specific action involving the CEO was a phone call with a representative from Sycamore. The court stated that this allegation, "without more, can[not] support a reasonably conceivable inference of a breach of the duty of care or loyalty."

The court also dismissed the plaintiffs' claim that the Essendant board committed waste, stating that "[i]t is not waste for a board to sign a merger agreement with one party after another party makes an overture of hypothetical interest."

Lastly, the court dismissed the aiding-and-abetting claim against Sycamore and Staples, holding that the plaintiffs failed to plead that Sycamore "knowingly participated" in any breach of fiduciary duty.

Registration Statement Liability

Northern District of California Grants in Part Motion to Dismiss Section 11 Claim, Dismisses Section 303 Claim

In re Restoration Robotics, Inc. Sec. Litig., No. 5:18-cv-03712-EJD (N.D. Cal. Oct. 18, 2019)

Judge Edward J. Davila dismissed in part a claim brought under Section 11 of the Securities Act, holding that most of the statements alleged to be misleading in Restoration Robotics' offering materials were not actionable. The court also dismissed in its entirety the plaintiff's claim that Restoration Robotics violated Item 303 of SEC Regulation S-K.

Restoration Robotics is a medical technology company that develops and commercializes a mechanical system that assists physicians in hair restoration procedures. The company held an initial public offering in late 2017. The plaintiff claimed that the offering materials the company filed with the SEC in connection with the IPO contained various false or misleading statements, in violation of Section 11, and failed to disclose certain known trends, in violation of Item 303.

With respect to the Section 11 claim, the court held that three of the alleged misstatements were inactionable puffery. The court reasoned that statements about a company's "belief," "goals" or "intentions" are not actionable under the securities laws when they are accompanied by meaningful cautionary language. Next, the court dismissed the Section 11 claim to the extent it was based on statements in the offering materials that Restoration Robotics formed "strong relationships" with customers, provided "extensive training and coaching" to physicians, and provided "easily implemented marketing tools" to doctors. In dismissing these statements, the court explained that the plaintiff was not alleging that the company did not attempt to do these things, but rather that the company failed to do these things effectively. Thus, the "Plaintiff's argument essentially crumbles into an efficacy, but not a falsity, argument." That is not sufficient to state a claim because "it is Plaintiff's burden to show falsity, not inadequacy." After dismissing the Section 11 claim on those two bases, the court sustained the complaint as to two additional alleged misstatements. First, the court held that the plaintiff adequately pleaded falsity as to the statement that Restoration Robotics' system "provides targeted precision and a cleanly scored incision" because "there are adequate facts from which this Court can infer the needle did not provide targeted precision or a cleanly scored incision." Second, the court held that the plaintiff adequately pleaded falsity with respect to the company's statements about its "installed base growth" because a significant portion of the systems sold had not yet been installed.

With respect to the Item 303 claim, the court stated that, in the Ninth Circuit, an Item 303 violation is actionable under Section 11. However, the plaintiff here failed to state a claim for such liability. First, the plaintiff claimed that Restoration Robotics failed to disclose the trend that overseas distributors were bulk purchasing the Restoration Robotics systems and then "warehousing" them. But the complaint alleged only one instance of such warehousing. Therefore, the complaint did not create "a plausible inference that this was a trend rather than an isolated event." Second, the plaintiff claimed that Restoration Robotics failed to disclose physicians' widespread discontent with the system due to lack of patient leads, effective marketing support and needle defects. But the complaint did not allege, or even allow the court to infer, that the defendants knew of any of those problems, and such knowledge is a required element of an Item 303 claim. Third, the plaintiff alleged that Restoration Robotics failed to disclose the known trend of physicians stalling purchases of the system. However, the complaint did not plead that this trend was occurring at the time of the IPO, much less that the defendants knew of the trend at the time of the IPO. Because fraud by hindsight is not actionable, the defendants could not be liable for failing to disclose that trend.

Scienter

SDNY Holds That a Cosmetics Company Misled Shareholders Concerning Its Operations in Brazil

In re Avon Sec. Litig., No. 19 Civ. 01420 (CM) (S.D.N.Y. Nov. 18, 2019)

Judge Colleen McMahon denied the dismissal of claims brought by a class of shareholders against a cosmetics company and certain of its officers alleging that they violated Sections 10(b) of the Securities Exchange Act by allegedly making false and misleading statements concerning the company's operations in Brazil and its purported concealment of the company's risk of bad debt.

The plaintiffs alleged that the company failed to disclose its relaxed credit policies for new sales representatives in Brazil, which exposed the company to a greater risk of bad debt. The court held that because the company "promoted recent success" in recruiting efforts, it triggered a duty to disclose the cause of that trend: the company's decision to adjust credit terms in Brazil to hire less creditworthy sales representatives. The court also reasoned that, even though the Brazilian economy was struggling at the time the statements were made, the company's "truth on the market" argument was weak because such an argument requires a fact inquiry into whether the macroeconomic conditions in Brazil and their effect on the company's debt load were conveyed to the market. The court also held that the company's statements were not protected forward-looking statements under the Private Securities Litigation Reform Act (PSLRA) because the company had no basis to tell shareholders in May 2017 that the company did not expect a level of debt to materially impact their revenue when at the time the company had thousands of delinquent accounts on its books. The court further held that the company's statements regarding its recruiting strategies were not inactionable puffery, noting that the Second Circuit does not recognize "repeated representations on the same topic, even where those representation[s] would otherwise be puffery" because the repetition itself communicates to investors what may be important and those statements may be material to investors.

> "The court noted that even though the company argued that the company's executives had no knowledge that sales representatives were not being trained at the time the statements were made, that does not 'negate the inference that their statements were false when made.'"

The plaintiffs also alleged that the company violated generally accepted accounting principles (GAAP) by recognizing revenue prematurely at the time of shipment to sales representatives instead of when the products were sold. The court agreed, relying on Second Circuit precedent that found allegations of accounting practices that recognized revenue "from the sale of undelivered equipment" to customers who were not creditworthy sufficient to survive a motion to dismiss. The plaintiffs also alleged that the company failed to disclose that it stopped training its sales representatives, which exposed it to a greater risk of its sales representatives' inefficiency. The court held that those statements were adequately alleged to be misleading because the company repeatedly referred to its training programs in public statements, thus requiring those disclosures to be complete and accurate. The court further noted that even though the company argued that the company's executives had no knowledge that sales representatives were not being trained at the time the statements were made, that does not "negate the inference that their statements were false when made."

Finally, the court held that the plaintiffs adequately alleged that the defendants acted with scienter. The plaintiffs alleged that the company's officers knew facts or had access to information suggesting that their public statements were not accurate. The plaintiffs alleged that the company's officers were "in charge" of the decision to lower credit standards to hire new representatives in Brazil. The court noted that because the company's officers received information about the true cause of the company's debt load, they had a duty to update their public disclosures "so as to not render their earlier representations misleading."

SEC Enforcement Actions

Fifth Circuit Holds That Supreme Court's Decision in *Kokesh v. SEC* Did Not Overrule Precedent Allowing District Courts to Order Disgorgement in SEC Enforcement Proceedings

SEC v. Team Res. Inc., No. 18-10931 (5th Cir. Dec. 30, 2019)

On November 5, 2019, the Fifth Circuit held that the Supreme Court's decision in *Kokesh v. S.E.C.*, 137 S. Ct. 1635 (2017), which held that disgorgement in SEC proceedings is a "penalty" under 28 U.S.C. § 2462, did not overrule precedent recognizing district courts' authority to order disgorgement in such proceedings.

The SEC filed an enforcement action against Kevin Boyles and two companies he created (Appellants), alleging that Mr. Boyles was scamming investors. While the case was pending, the Supreme Court decided *Kokesh v. S.E.C.*, holding that disgorgement in SEC enforcement proceedings is a "penalty" under 28 U.S.C. § 2462 and therefore is subject to a five-year statute of limitations.

The matter involving Mr. Boyles settled, and the SEC moved for remedies and final judgment, seeking disgorgement. Appellants responded that the disgorgement amount requested was barred by the five-year statute of limitations under 28 U.S.C. § 2462, and that after *Kokesh*, district courts no longer have authority to order disgorgement in SEC proceedings. After the SEC amended the requested amount to seek only that within the five-year statute of limitations, the district court ordered disgorgement, noting that the *Kokesh* opinion itself stated that "[n]othing in [its] opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings." An appeal to the Fifth Circuit followed.

The Fifth Circuit rejected Appellants' argument that, because disgorgement is a "penalty" under 28 U.S.C. § 2462, it is not an equitable remedy that courts may impose in SEC enforcement proceedings. The Fifth Circuit reasoned that *Kokesh* made clear that the sole issue in the case was whether disgorgement is subject to the five-year statute of limitations; the Supreme Court did not purport to decide that disgorgement could never be classified as equitable. "We are thus not convinced that *Kokesh* quietly revolutionized SEC enforcement proceedings while at the same time explicitly stating it was not doing so." The Fifth Circuit held that, because *Kokesh* did not unequivocally overrule precedent that district courts have the authority to order disgorgement in SEC enforcement proceedings, the Fifth Circuit would not do so.

Appellants also argued that, even if the district court had the authority to order disgorgement, it erred by failing to give Appellants discovery or hold an evidentiary hearing. The Fifth Circuit held that the district court had, in fact, authorized discovery, but Appellants failed to seek any. It also held that the settlement agreement did not create the right to an evidentiary hearing, and Appellants never moved for one, so no rights had been violated by not holding one.

Securities Exchange Act

Second Circuit Upholds Dismissal of Securities Fraud Claim for Failure to Plead Underlying Criminal Conspiracy With Particularity

Gamm v. Sanderson Farms, Inc., No. 18-0284-cv (2d Cir. Dec. 10, 2019)

The Second Circuit affirmed the dismissal of claims brought by a putative class of shareholders under Section 10(b) of the Securities Exchange Act against a poultry processing company, alleging that the company's statements that they competed with other companies was false because they allegedly colluded with other poultry companies in an anti-competitive conspiracy to affect the price of chicken.

The district court had previously found that the plaintiffs had failed "to support their allegation of a chicken supply reduction conspiracy with particularized facts." In upholding the lower court's ruling, the Second Circuit reasoned that the plaintiffs' securities fraud claims were subject to a heightened standard under the PSLRA, and required facts to be pleaded with particularity. The Second Circuit rejected the plaintiffs' argument they were only required to plead the underlying antitrust conspiracy with plausibility standard because the Section 10(b) claim was "entirely dependent upon the predicate allegation" of the company's participation in the price-fixing scheme. The Second Circuit thus determined that without pleading the underlying assertion with particularity, the plaintiffs "had not met the burden of explaining what rendered the statements materially false or misleading."

SDNY Dismisses Complaint Against Inverse Exchange-Traded Fund Company

In re ProShares Trust II Sec. Litig., No. 19cv0886 (DLC) (S.D.N.Y. Jan. 3, 2020)

Judge Denise Cote granted a motion to dismiss a putative class action asserting claims under Section 10(b) of the Securities Exchange Act against a short-term futures exchange-traded fund (ETF) company for allegedly misleading investors about the risks of potential losses in investing in the ETF. The plaintiffs alleged that the registration for the ETF (which was designed to measure and compensate for the expected volatility of the S&P 500) omitted that the fund's own daily rebalancing through the purchase and sale of certain futures contracts could itself drive up the price of those futures contracts and the level of market volatility and thus drive down the value of the ETF shares.

The court concluded that the plaintiffs failed to adequately allege a material misstatement or omission. The court reasoned that "[r]eading the Registration Statement 'cover-to-cover,' the disclosures and representations 'taken together and in context' could not have misled a reasonable investor about the nature of the [ETF] and the risks associated with this complex financial product." The registration statement adequately disclosed that "substantially all" of the ETF's assets were invested in futures contracts, which can be "highly volatile," and that the large positions in these contracts that the fund could acquire increases the risk of illiquidity and the risk of "large losses when buying, selling, or holding such instruments." The court thus determined that the disclosures would have put a reasonable investor on notice that "the Fund's own conduct in purchasing and selling [] futures contracts could affect market liquidity and drive down the value of [ETF] shares."

Utah District Court Denies Motion To Dismiss Allegations That Company Operated an Illegal Pyramid Scheme

Smith v. LifeVantage Corp., No. 2:18-cv-00621 (DN) (PMW) (D. Utah Dec. 5, 2019)

Judge David Nuffer granted in part and denied in part a motion to dismiss claims brought by distributors against a distribution company alleging that it violated Section 12(a)(1) of the Securities Act and Section 10(b) of the Securities Exchange Act by operating an illegal pyramid scheme and selling fraudulent unregistered securities.

The plaintiffs alleged that the combination of a compensation plan, policies and procedures, and a distributor enrollment form was "an offering for investment and a security under federal securities laws." The court held that the plaintiffs' distributorship in the company was a security. The court reasoned that investment into the compensation plan where profits predominantly originated from "'the efforts of others, namely of the downline members,' falls under the definition of an investment contract governed by securities laws." The court also held that the plaintiffs alleged enough plausible facts to state a claim under Section 10(b) via a scheme liability theory. The court reasoned that the plaintiffs had adequately alleged that the company participated in an "illegitimate, sham or inherently deceptive transaction where [its] conduct or role ha[d] the purpose and effect of creating a false appearance." The court pointed to the plaintiffs' allegations that the company hired professional marketers to pose as "success stories" to convince potential recruits that they can receive, though unlikely, great financial rewards.

The court also found that the plaintiffs had adequately alleged scienter. The plaintiffs alleged that seven out of the eight ways that distributors earned money were based on recruiting, and that method was designed by the company. The court determined that the plaintiffs had adequately alleged that the inherently deceptive act of presenting a pyramid scheme "as a legitimate business opportunity" supported the inference that the company knew it was engaged in a scheme.

Securities Fraud Pleading Standards

Seventh Circuit Holds RICO Bar for Actionable Securities Fraud Inapplicable to Tax Shelter

Menzies v. Seyfarth Shaw LLP, No. 18-3232 (7th Cir. Nov. 12, 2019)

The Seventh Circuit affirmed, in relevant part, the district court's ruling that the Private Securities Litigation Reform Act's amendment to the Racketeer Influenced and Corrupt Organizations Act (RICO) barring a cause of action for conduct that would have been "actionable as fraud in the purchase or sale of securities" did not bar the plaintiff's RICO claim.

In 2002, an insurance executive's financial advisors pitched him a strategy to avoid tax liability on capital gains from major stock sales. The IRS would later deem this strategy an abusive tax shelter. In 2006, the insurance executive sold over $64 million worth of stock in his company. He did not report the stock sale or any capital gains related to the sale on his 2006 tax return. Following a three-year audit and facing potential legal action and fines, the insurance executive entered a settlement with the IRS, under which he paid over $10 million in back taxes, penalties and interest. Alleging that his tax underpayment was the result of a fraudulent tax shelter, he later brought claims against his former tax lawyer, law firm and two financial services firms under RICO and Illinois law. The district court granted the defendants' motion to dismiss for failure to state a claim.

On appeal, the defendants argued that the RICO bar applies because the point of the tax shelter was for the insurance executive to avoid taxable gains on the stock sale, making the alleged fraud "in connection with" the sale of a security. The Seventh Circuit rejected this argument because the complaint focused not on the stock sale, but on its tax consequences. The insurance executive's RICO claim was based on allegations related to the defendants selling him an allegedly fraudulent tax shelter. To bring a securities fraud claim, the insurance executive would have been required to plead alleged losses as a direct consequence of the defendants' misrepresentations related to the stock sale. Further, the complaint did not challenge any aspect of the stock sale and represented that it was entirely lawful. Accordingly, the insurance executive's allegations did not amount to actionable securities fraud and the RICO bar does not apply.

Despite the RICO bar not applying to the plaintiff's claims, the court affirmed the dismissal of the RICO claim because he failed to plead a pattern of racketeering.

EDNY Dismisses Claims Against Tax Preparation Services Company for Failure To Meet Securities Fraud Pleading Standards

In re Liberty Tax, Inc. Sec. Litig., No. 2:17-CV-07327 (NGG) (RML) (E.D.N.Y. Jan. 16, 2020)

Judge Nicholas G. Garaufis dismissed claims brought by a putative class of investors against a tax preparation services company and certain of its officers, alleging that the defendants violated Section 10(b) and Section 14(a) of the Securities Exchange Act by making false and misleading statements about the company's risk factors, internal controls, compliance efforts and executive compensation.[6] The plaintiffs alleged that the former CEO, who was also the controlling shareholder of the company, used his position to inappropriately advance his personal interests. The plaintiffs alleged that the company omitted information about the CEO's misconduct from its risk factors disclosures, and also failed to disclose other information about the CEO's other income.

The court dismissed the plaintiffs' claims, finding that they failed to adequately plead a material misrepresentation or omission, and loss causation. The court found that the defendants did not misrepresent the risks associated with the CEO's control of the board of directors because the CEO's alleged misconduct was entirely unrelated to his control of the board and the risk disclosures were too general for an investor to reasonably rely on. The court further found that the defendants' statements discussing their internal controls and commitment to ethics were inactionable "puffery." The court rejected the argument that the omissions met the standard for materiality under either Item 303 or Item 402 of SEC Regulation S-K. Lastly, the court held that, while the plaintiffs had alleged a causal connection between the CEO's misconduct and the diminished productivity of the company, they could not rely on allegations that the CEO set a "damaging Tone at the Top . . . to explain with particularity how the concealment of [the CEO's] ethical lapses in Virginia caused independently run franchises across North America to process fewer tax returns." The court thus found subsequent disclosures about diminished productivity and increased losses did not "amount to corrective disclosures that revealed the truth about the company's underlying condition," and did not establish loss causation.

SDNY Finds Statement Concerning Sexual Misconduct Materially Misleading

Constr. Laborers Pension Trust for S. Cal. v. CBS Corp., No. 18-7796 (S.D.N.Y. Jan. 15, 2020)

Judge Valerie Caproni denied in part and granted in part motions to dismiss claims brought by a putative class of investors under Section 10(b) of the Securities Exchange Act alleging that a mass media company and several of its officers made materially misleading statements by failing "to disclose the risk that journalists would uncover and expose [the former CEO's] misconduct and force [the former CEO] out" during the #MeToo movement.

The court found that one of the alleged statements was materially misleading. The plaintiffs had alleged that the former CEO's statement that the company was still learning about the alleged sexual misconduct occurring at the company was misleading because at the time the statement was made the former CEO was "actively seeking to conceal his own past sexual misconduct" from the company and the public. The court found that it was "barely plausible that a reasonable investor would construe [the former CEO's] statement as implicitly representing that he was just learning of problems with workplace sexual harassment at CBS." The court found the misstatement to be adequately alleged to be material because the statement "could be construed as a representation that [the former CEO] had personally engaged in no sexual misconduct that could be a liability 'during a time of concern' when media executives were being scrutinized." The court also reasoned that a reasonable investor could have relied upon the statement as a representation of the former CEO's and the company's "lack of high-level exposure to the #MeToo movement."

The court found the remaining statements to be inactionable. Statements about the company's business conduct and ethics code were "inactionable puffery" because they stated the company's beliefs and were not facts. The court rejected the plaintiffs' argument that the company's risk disclosures were misleading because they did not allege that the company was aware of the risk of the former CEO's termination for sexual misconduct at the time it made the disclosures. Finally, the court determined that Item 303 did not create a duty to disclose the former CEO's alleged misconduct because "the chain of causation between the alleged [misconduct] and [the company's] future financial performance is far too tenuous."

D. Mass Dismisses Claims Against Biopharmaceutical Company for Failure to Adequately Plead Falsity and Scienter

LSI Design & Integration Corp. v. Tesaro Inc., No. 18-cv-12352-LTS (D. Mass. Nov. 13, 2019)

Judge Leo T. Sorokin dismissed claims brought by a putative class of investors against a biopharmaceutical company, alleging that the company violated Section 10(b) of the Securities Exchange Act by purportedly misleading investors about the company's cash flow and ability to fund its operations in 2017 in SEC filings and statements made at a health care conference.

The court found that none of the alleged misstatements were false or misleading. The plaintiffs failed to adequately allege that the company's existing cash and cash equivalents would be insufficient to fund the company's operations in 2017, and that the plaintiffs admitted that the company's ending cash position in 2016 was stable and sufficient. The court also found that the statements made at a health care conference were "immaterial as a matter of law" because they fell squarely within the PSLRA's "statutory safe harbor for certain forward-looking statements," including "statement[s] of future economic performance."

The court also determined that the complaint failed to adequately allege a strong inference of scienter. The court determined that the complaint offered no facts showing that the company intended to defraud investors. While the company likely had actual knowledge about the company's financials, this knowledge was not indicative of an intent to deceive investors and did not demonstrate a high degree of recklessness.

Northern District of California Allows Claims to Proceed in Case Arising Out of Alleged Price-Fixing in Generic Drug Industry

Evanston Police Pension Fund v. McKesson Corp., No. 18-cv-06525-CRB (N.D. Cal. Oct. 30, 2019) (order clarifying decision Dec. 19, 2019)

Judge Charles R. Breyer denied in part a motion to dismiss filed by McKesson Corporation, finding the plaintiffs adequately alleged that McKesson was aware of, or was reckless in not knowing about, purported price-fixing agreements in the generic drug industry, and that such awareness rendered McKesson's statements about its business and the industry in which it operates false or misleading.

The case arose out of government investigations into purported anti-competitive agreements in the generic pharmaceutical industry, which led the attorneys general from 49 states to file a complaint alleging that the generic drug industry is rife with price-fixing and market-allocation agreements. McKesson, for the most part, is a generic drug wholesaler, not a generic drug manufacturer. Nevertheless, the plaintiffs asserted that McKesson either participated in the alleged anti-competitive conduct or, at a minimum, was aware of and profited from the illegal agreements. They further claimed that McKesson's knowledge of the price-fixing arrangements rendered certain of its public statements false or misleading.

The court dismissed the plaintiffs' claims to the extent premised on McKesson's actual involvement in the price-fixing conspiracy, holding the complaint failed to adequately plead McKesson's participation. The court reasoned that even if the complaint alleged the type of "parallel conduct" that can be indicative of price-fixing, it failed to sufficiently allege the additional circumstantial conduct, or "plus factors," that the Ninth Circuit requires in order to create a plausible inference of McKesson's participation in the unlawful agreement.

With respect to McKesson's awareness of the agreement, however, the court found that the plaintiffs adequately pleaded their claim. Citing alleged statements by McKesson executives touting their knowledge of the generics market, as well as the magnitude of the price-fixing conspiracy and the importance of generics pricing to McKesson's revenues, the court concluded that the company's executives knew or were reckless in not knowing about the price-fixing conspiracy. Given that knowledge, the plaintiffs sufficiently alleged that three categories of statements by McKesson were false or misleading.

First, McKesson executives repeatedly attributed the company's increased profitability to generic drug price increases driven by "supply disruptions." McKesson identified the reasons for such disruptions, but did not disclose the alleged price-fixing conspiracy. The court held that, because McKesson undertook to explain *why* generic drug prices had increased, it was obligated to disclose the true reasons, including that at least some portion of the price increase was due to the price-fixing conspiracy. McKesson's failure to do so rendered its statements misleading.

Second, McKesson executives described the generic drug market as competitive, which was false in light of their awareness that the market was tainted by extensive anti-competitive price-fixing.

Third, the plaintiffs claimed that McKesson's financial results were misleading because McKesson failed to disclose that its results were in part based on the industry-wide price-fixing. The court rejected the plaintiffs' broad theory that all financial statements are rendered false any time a defendant fails to disclose alleged company fraud. However, where a company explains the *source* of its revenue and the *reasons* for its performance, it is bound to do so in a way that is not misleading. Here, the court held that McKesson's statements that its financial performance was due to "legitimate market forces" was misleading because, by affirmatively attributing its performance to certain factors, it was required to also attribute its performance to the alleged price-fixing conspiracy.

"Citing alleged statements by McKesson executives touting their knowledge of the generics market, as well as the magnitude of the price-fixing conspiracy and the importance of generics pricing to McKesson's revenues, the court concluded that the company's executives knew or were reckless in not knowing about the price-fixing conspiracy. "

Endnotes

1. Skadden represented BlackRock Advisors LLC and two trustees in the case.
2. Skadden represented the special committee of the board of directors of Oracle Corporation in its acquisition of NetSuite Inc.
3. Skadden represented the defendants in the case.
4. Skadden represented the defendants in the case.
5. Skadden represented the individual defendants in the case.
6. Skadden represented a former officer of Liberty Tax, Inc. in the case.


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