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Quarterly Survey of SEC Rulemaking and Major Court Decisions (January 1, 2023—March 31, 2023)

By Kenneth M. Silverman and Brian Katz[*]

This issue's Survey focuses on the U.S. Securities and Exchange Commission's ("SEC") rulemaking activities and other decisions relating to the Securities Act of 1933, as amended (the "1933 Act"), the Securities Exchange Act of 1934, as amended (the "1934 Act"), and other federal securities laws from January 1, 2023 through March 31, 2023.

This quarter, the SEC proposed nine new rules and approved three final rules. The SEC's latest rule changes and proposals are largely geared towards modernizing the mechanisms of capital markets infrastructure and bolstering protections to individuals and entities from cybersecurity and privacy risks.

Final Rules

SEC Implements Amendments to Shorten the Securities Settlement Cycle

On February 15, 2023, the SEC adopted a final rule to amend Rule 15c6-1 under the 1934 Act to shorten the standard settlement cycle of routine securities trades from two business days following the trade date to one business day following the trade date. In industry terms, this is referred to as changing the settlement cycle from "T+2" to "T+1." The current T+2 settlement cycle means that securities transactions settle two business days after the trade date. The new rule, which will apply to most securities with the exception of certain government securities, commercial papers and certain bank debt securities, will shorten the settlement time frame to one business day after the trade date.

The final rule also shortens the settlement cycle for firm commitment offerings, including initial public offerings, that price after 4:30 p.m. Eastern Time from four business days to two business days. Most parties to firm commitment offerings should not be greatly impacted by this amendment because most parties already use a T+2 settlement cycle for these offerings.

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Interested parties should note that the existing "override provision," which allows parties, often in the context of certain option trades, to agree on a settlement cycle outside of the normal requirements at the time of the transaction, will remain in place. When the SEC first adopted the override provision, it stated that the use of the override provision is intended to apply only to unusual transactions, such as seller's option trades, that typically settle as many as 60 days after execution as specified by the parties to that trade at the time of execution. In light of the amendments to the settlement cycles described above, the SEC noted that the override provision continues to apply only to those unusual transactions.

The SEC's decision to shorten the settlement cycle was long-anticipated and widely supported by industry and market participants who have recognized the benefits of improving liquidity and reducing risk imposed by delays in settlement times. This change puts the United States in line with a handful of other markets at the forefront of change. The plans largely seek to match China's equity market, which already functions on a T+0/T+1 settlement cycle, and are similar to changes recently implemented in India where a gradual phase-in of a T+1 settlement cycle began implementation this year. Canada has also introduced plans to transition to a T+1 system, and regional market authorities in Europe and South America have released statements indicating they are keen to follow suit. The SEC has communicated that this transition is the first step towards potentially implementing a same day (T+0) or an instantaneous settlement cycle.

The amendments to the rules governing the settlement cycles will become effective on May 28, 2023.

Proposed Rules

SEC Proposes Rule Prohibiting Conflicts of Interest in Certain Securitization Transactions

On January 25, 2023, the SEC proposed new rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Dodd-Frank Act") prohibiting an underwriter, placement agent, initial purchaser, or sponsor (collectively, "participants") of an asset-backed security (including a synthetic asset-backed security) within the meaning set forth in Section 3 of the 1934 Act (an "ABS"), or any affiliate or subsidiary of any entity, from engaging in any transaction that would involve or result in certain material conflicts of interest that are economically adverse to the interests of ABS investors. This initiative is a recycling of a proposal first published in 2011, when it was met with

substantial industry pushback that eventually led to it being shelved by the SEC. Much of the preamble of the release seeks to address these comments received 12 years ago, but the proposal remains largely the same.

The proposed rule sets out specific transactions that are explicitly deemed to be a material conflict of interest, alongside a number of other fact-dependent circumstances where a conflict could be found. Under the proposed rules, the following conflicted transactions would be generally prohibited if the presence of such transaction would create a substantial likelihood that a reasonable investor would consider it important in their decision making: (1) a short sale of an ABS; (2) the purchase of a credit default swap or other credit derivative where participants would receive payments upon the occurrence of an adverse event with respect to the ABS; and (3) the purchase or sale of any financial instrument (other than the relevant ABS) or entry into a transaction through which the participant would benefit from the actual or potential (a) adverse performance of the asset pool supporting the ABS; (b) loss of principal monetary default or early amortization of the relevant ABS; or (c) a decline in market value of the relevant ABS. Particularly as it pertains to the last variable, the proposal is sweeping in the enumeration of circumstances that a reasonable investor may consider as material, creating potentially large disclosure burden for participants.

As an example of a scenario that could give rise to a conflict of interest, an underwriter might be incentivized to include lower-quality assets in an ABS in order to increase its own profits, even if this would increase the risk to investors. Certain exceptions to the proposed rule apply where a participant is engaging in risk mitigating hedging activities, liquidity commitments, and certain bona fide market-making activities as defined. If the proposal is implemented, it will be interesting to see whether the scope of carve outs will expand after industry comment.

The public comment period on the proposed rule closed on March 27, 2023, and it remains to be seen whether the initiatives will be adopted in their current form this time around. In line with the broader mandates of the Dodd-Frank Act, the proposed rules reflect the SEC's ongoing efforts to enhance transparency and protect investors in the asset-backed securities market, and may have a significant impact on the industry if they are adopted. If implemented as proposed, private fund managers who sponsor or manage ABS or certain collateralized loan obligations would need to develop compliance frameworks that can flag a broad range to conflict scenarios beyond that required in current disclosures to address the relative ambiguity of the rule, at least until market standards are established or further guidance is released.

Further Safeguarding Advisory Client Assets

On February 15, 2023, the SEC proposed a series of rules under the Investment Advisors Act of 1940, as amended (the "Advisors Act"), to address how investment advisors safeguard client assets. The proposal broadens the scope of assets currently covered under Rule 206(4)-2, known as the "Custody Rule," by enhancing custodial protections, changing exemptions for privately held securities and modifying the existing audit provisions. The current Custody Rule sets forth certain requirements for registered investment advisors regarding their obligations to maintain client funds and securities in a proper manner with duly qualified custodians. In line with these requirements, the proposal also adds new recordkeeping requirements and makes corresponding amendments to Form ADV to improve the quality of data on such matters made available to the SEC and general public. With this proposal, the SEC would remove custody obligations from Section 206 of the Advisers Act and recodifying them under new Rule 223-1 of the Advisers Act (the "Safeguarding Rule").

First, if enacted, the Safeguarding Rule would expand the scope of assets covered under the Custody Rule to include funds, securities, or other positions held in a client's account. This expansion would cover all client assets held in advisory accounts, including physical assets or cryptocurrencies, which were not explicitly included in the Custody Rule. Furthermore, the proposal explicitly includes assets in which an advisor has discretionary authority.

Under the current Custody Rule, investment advisers with custody of client assets are required to undergo an annual surprise examination by an independent public accountant. The proposed amendments would replace the surprise examination requirement with a requirement for an annual audit of an adviser's custody controls by an independent public accountant.

The proposed Safeguarding Rule would also add new requirements for advisers that maintain client assets in a pooled investment vehicle, such as a private fund. The amendments would require advisers to provide additional information to clients about their ownership interests in the pooled investment vehicle and to obtain an annual audit of the financial statements of the vehicle by an independent public accountant.

The SEC has also proposed changes to the definition of "qualified custodian," which is used to determine whether an adviser's custody practices comply with the Custody Rule. The proposed amendments would expand the definition to include entities that are regulated in foreign jurisdictions and that provide custody services in accordance with those regulations.

Finally, the SEC proposed amendments to the Custody Rule's

exemption for advisers deemed to have custody solely because they deduct advisory fees from client accounts. The proposed amendments would require advisers to obtain a surprise examination or an annual audit of their controls relating to this practice.

The Safeguarding Rule aims to modernize the rule and address certain custody practices that have become more prevalent in recent years. These proposals are likely spurred in part by the significant turmoil financial markets have faced in the last 12 months due to cryptocurrencies and other digital asset fluctuation.

Public comments on the proposal are due by May 8, 2023. Investment funds and advisors should determine the extent to which they hold assets within the scope of the proposal and examine their current policies and procedures to flag areas for enhancement if the rules are implemented. The proposed timeline does not provide much time for large advisors to revamp compliance frameworks, so potentially affected advising houses would be wise to begin the groundwork now.

Cybersecurity and Privacy Proposals

Proposed Privacy Act Amendments

On February 14, 2023, the SEC issued a proposed rule to revise its internal regulations under the Privacy Act of 1974, as amended (the "Privacy Act"), governing the collection, maintenance, use and dissemination of information about individuals maintained by federal agencies.

The proposed rule includes updates to the SEC's internal policy and procedures and, in particular, seeks to afford new protections to data belonging to individuals. The updates would clarify the purposes for which an individual's information is collected, the entities with whom the information may be shared, and the safeguards in place to protect the information.

As it impacts individuals, the proposed changes would update the SEC's Privacy Act notices, which are provided to individuals when their personal information is collected. The updated notices would include additional information about the SEC's privacy practices, including the purpose of the information collection, the types of information collected, and the rights of individuals to access and correct their information. Additionally, the proposed changes would establish new procedures for responding to requests by individuals to access, correct, or delete their personal information. These procedures would include requirements for verifying the identity of the requester and responding within specified timeframes. Furthermore, a key change under the

proposals would broaden the definition of personal information to include additional data elements that are commonly used in modern data collection and analysis, such as biometric data and internet browsing history.

The SEC has stated that these proposed changes are necessary to keep pace with advancements in technology and to ensure that the agency is able to better fulfill its obligations under the Privacy Act in line with modern data privacy practices. The agency is also seeking to align its practices with those of other federal agencies and with international privacy standards.

Public comments on the proposal are due by the later of (i) 30 days after the date of publication of the proposal in the Federal Register or (ii) April 17, 2023.

Proposed Regulation S-P Amendments

On March 15, 2023, the SEC proposed amendments to Regulation S-P to amend, among other things, the current "safeguards rule" under Rule 248.30(a) that requires broker-dealers, registered funds and investment advisers to adopt written policies and procedures to protect sensitive customer records and information. The body of amendments aim to modernize Regulation S-P and provide clarity to covered entities regarding their safeguarding obligations.

Regulation S-P, also known as the Privacy of Consumer Financial Information Rule, was first adopted in 2000 under the Gramm-Leach-Bliley Act. These proposed changes would be the first amendments to the rule since it was adopted.

One of the key proposed changes to Regulation S-P is the inclusion of a definition of "nonpublic personal information." The proposed definition is intended to provide clarity to firms on what types of information must be safeguarded. The definition would include information that is not publicly available and can be used to identify an individual, such as a Social Security number, a driver's license number or a passport number.

The SEC is also proposing to require broker-dealers and investment advisers to provide customers with an initial privacy notice at the time they establish a relationship, instead of within a reasonable time after the relationship is established. This change is intended to ensure that customers receive timely and meaningful information about a firm's privacy policies and practices.

Another proposed change to Regulation S-P is the addition of a requirement that firms include in their privacy notices the right of customers to opt out of having their nonpublic information used for purposes outside of compliance with regulatory bodies, such as for marketing data. This change would bring Regulation S-P in line with aspects of existing privacy laws in other jurisdic-

tions, such as the European Union's General Data Protection Regulation. Further in line with the laws of other jurisdictions, the amendments to Regulation S-P would seek to establish a federal minimum standard for providing notifications to all customers of covered entities in the event of a data breach. While many laws exist at the state level regarding a company's obligations in the wake of a data breach, the amendments here seek to provide a consistent baseline of disclosure for customers regardless of residency.

Overall, the proposed changes to Regulation S-P are intended to provide greater flexibility to financial institutions while maintaining strong consumer privacy protections. Public comments on the proposal are due by the June 5, 2023, and it is likely that there will be significant input from both financial institutions and consumer advocacy groups before the changes are finalized.

Regulation SCI Amendments

Regulation Systems Compliance Integrity ("Regulation SCI") is a set of rules established by the SEC in 2014 to enhance the integrity, resiliency, and reliability of securities market infrastructure. On March 15, 2023, the SEC proposed amendments to Regulation SCI that would update and strengthen the rules to reflect ongoing technological developments and the latest market practices by expanding the scope of covered entities and the compliance procedures necessary to properly adhere.

The proposed amendments would primarily expand the scope of Regulation SCI to cover registered security-based swap data repositories ("SBSDRs"), certain broker-dealers and all previously exempt clearing agencies that were not subject to the rule. At present, Regulation SCI primarily applies to self-regulatory organizations, including stock and options exchanges, certain registered clearing agencies, and certain agencies such as the Financial Industry Regulatory Authority ("FINRA") and the Municipal Securities Rulemaking Board ("MSRB").

The proposed rule would also add new policies and procedures required under Regulation SCI by heightening and modifying reporting requirements and internal policies. For example, the proposals would add to the established list events that trigger the mandatory reporting of such cybersecurity incidents to the SEC and testing requirements imposed on entities to ensure that their internal systems are safe from cyberattacks. The latter-mentioned "stress tests" provide that SCI-covered entities engage in periodic capacity and breach testing of their systems as well as maintain internal recordkeeping of the systems to be managed and tested under the regulation. In the event of actual cybersecu-

rity breaches, data leaks, systems failures or other sorts of events, covered entities must report these events to the SEC and under many instances make a public disclosure.

If implemented as proposed, the changes to Regulation SCI would impose further compliance and cybersecurity requirements on currently covered entities and potentially encompass a broad swath of new parties as the SEC is working to strengthen the cybersecurity infrastructure of the nation's securities markets. As routinely witnessed outside of the securities space, cybersecurity attacks and systems failures can cause havoc and erosion of public faith. Public comments on the proposal are due by June 13, 2023.

Cybersecurity Risk Management Proposal

On March 15, 2023, the SEC proposed a new rule and amendments to the 1934 Act's existing recordkeeping rules to require broker-dealers, clearing agencies, major security-based swap participants, the MSRB, national securities associations and exchanges, security-based swap data repositories and swap dealers, and transfer agents (collectively, "covered entities") to address cybersecurity risks through new policies and procedures that require immediate notification to the SEC of cybersecurity incidents and public disclosure of such events. Primarily addressed under a new Rule 10 and new Form SCIR, the amendments round out this quarter's suite of rulemaking seeking to modernize cybersecurity and privacy regulation.

Aimed largely at improving market transparency and to create public accountability for internal systems failures, the proposals are designed to require the establishment and maintenance of reasonable internal procedures to address cybersecurity risks specific to a particular entity. If implemented, the proposal would also require covered entities to engage in periodic assessments of their cybersecurity risk posture and to implement controls to address any identified vulnerabilities. These assessments would require that covered entities categorize and prioritize cybersecurity risks based on their specific needs and to flag any third parties that receive or have access to sensitive information or internal systems as part of that entity's business.

The proposed rule would additionally require risk detection and mitigation mechanisms beyond the assessment requirements that complement the proposal's broader edict to implement new cybersecurity policies. As an example, entities must have policies and training procedures that address more modern vulnerabilities to internal systems such as email phishing or social engineering, in addition to more widely known threats such as malware or computer hacking.

While the proposed rules and amendments to Regulation SCI share some similarities to the cybersecurity proposals addressed here such as the aforementioned reporting requirements, there are some key differences between the two. The proposed cybersecurity rules would apply to a broader range of entities, including investment companies and advisers, while Regulation SCI applies primarily to securities exchanges and clearing agencies. Additionally, the proposed rule places a greater emphasis on disclosures to investors, while Regulation SCI focuses more on the resiliency and reliability of market infrastructure. Public comments on the proposal are due by June 5, 2023.

Proposed Securities Exchange Rules

On October 26, 2022, the SEC adopted Rule 10D-1 of the 1934 Act, which requires national securities exchanges to adopt new listing standards providing for the recovery of erroneously awarded incentive-based compensation received by current and former directors and officers, which is known as the "Clawback Policy." On February 22, 2023, the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq") submitted proposals to the SEC to amend their respective listing requirements to incorporate a Clawback Policy as part of their listing standards.

Pursuant to Rule 10D-1, listed companies on a national securities exchange are required to adopt and comply with a written Clawback Policy. Such policy must require the listed company to recover erroneously awarded incentive-based compensation reasonably promptly, subject to limited exceptions. The use of the phrase "reasonably promptly" does not provide listed companies with a clear timeline on when they must recover such erroneously awarded compensation. The NYSE and Nasdaq proposals attempt to clarify the phrase "reasonably promptly." Under their proposals, when evaluating whether a listed company is recovering erroneously awarded incentive-based compensation, both the NYSE and Nasdaq would consider whether the listed company is pursuing an appropriate balance of cost and speed in determining the appropriate means to seek recovery, and whether the listed company is recovering such compensation through appropriate means based on the facts and circumstances.

Both the NYSE and Nasdaq proposals closely track Rule 10D-1. In addition, among other things, each proposal imposes the commencement of delisting procedures if a listed company fails (i) to adopt a compliant Clawback Policy within 60 days following the effective date of the proposed listing standard (the "Policy Adoption Deadline") and (ii) to comply with its Clawback Policy "reasonably promptly" (as described above) after a clawback obligation arises.

A company listed on NYSE that fails to adopt a compliant Clawback Policy by the Policy Adoption Deadline would be required to notify NYSE within five days following the Policy Adoption Deadline of such company's failure to adopt a Clawback Policy. The listed company would also be required to issue a press release disclosing its delinquency. NYSE's proposal provides for two consecutive six-month cure periods (the second of which is subject to NYSE's discretion) during which a company's securities may continue to be traded despite failing to adopt a compliant Clawback Policy. If a company listed on NYSE fails to comply with its Clawback Policy "reasonably promptly" after a clawback obligation arises, NYSE will immediately suspend trading in the company's securities and commence delisting procedures.

A company listed on Nasdaq that fails to adopt a compliant Clawback Policy by the Policy Adoption Deadline or comply with its Clawback Policy "reasonably promptly" after a clawback obligation arises would be required to submit a plan to Nasdaq to regain compliance generally within 45 days of Nasdaq's notice of noncompliance. The Nasdaq staff would have discretion to provide such company with up to 180 days to cure the deficiency. Unlike NYSE, Nasdaq's proposal would not impose immediate delisting procedures if a listed company fails to comply with its Clawback Policy "reasonably promptly" after a clawback obligation arises.

Current and prospective listed companies on either exchange should be mindful of the upcoming requirements and prepare to adopt a Clawback Policy if one is not already in place.

The comment period for each exchange's proposal closed on March 15, 2023, and the standards are now subject to SEC approval. At the latest, the final listing standards are to take effect on November 28, 2023.

SDNY Dismisses Complaint Alleging Peloton Misled Investors

In November 2021, a class of investors sued Peloton Interactive Inc. ("Peloton" or the "Company") in the Southern District of New York, accusing the Company of intentionally misleading investors to believe that the Company expected long-term high demand for its products and services. The investors claimed that in actuality, Peloton knew that the spike in demand it experienced from COVID restrictions would not last. However, Peloton filed a motion to dismiss the complaint last year, and this month, Judge Andrew Carter Jr. granted Peloton's motion to dismiss the claims.

Peloton's stock had dropped from $104.34 in August 2021, to $31.84 in January 2022, as the Company released a series of disclosures stating its inventory was higher than consumer demand. In November 2021, Peloton revised its full-year revenue

guidance downward, noting customer demand had fallen due to more options to exercise outside of the home becoming available.

Investors characterized risk warnings in Peloton's disclosures as "boiler-plate" and "garden-variety." They also claimed that Peloton knew from internal sales data that the increased demand from COVID restrictions would not last. Peloton, however, argued that it accurately informed investors what to expect and adjusted guidance when necessary.

Judge Carter agreed with Peloton, holding that many of Peloton's statements were "forward-looking" and contained "meaningful cautionary language," and thus fell within the safe harbor of the Private Securities Litigation Reform Act. Peloton's statements contained the warning that " '[a]ctual results may differ materially from those contained in or implied by these forward-looking statements due to risks and uncertainties associated with our business." Judge Carter also held that other statements were corporate puffery and too vague or broad for any investor to rely on them. The opinion further noted that Peloton had exceeded its sales guidance after adjusting for a drop in demand. The court granted the investors until the end of April to file a second amended complaint.

City of Hialeah Employees Retirement System v. Peloton Interactive Inc. et al., case number 1:21-cv-09582 (SDNY).