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The Collision Between the UCC and the Securities Act: Foreclosure Sales of Unregistered Securities *By Wendy Gerwick Couture*

Reputational Sanctions as a Self-Regulatory Tool of China's Stock Exchanges: Recent Developments of the Law and Practice *By Robin Hui Huang*

Cooking Books? The Valuation Treadmill - Book Review *By Marc Gross*

The DOJ'S Kleptocracy Asset Recovery Initiative and its Progeny *By Robert A. Barron*

Quarterly Survey of SEC Rulemaking and Major Appellate Decisions *By Kenneth M. Silverman and Brian Katz*

Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (July 1, 2022 – September 30, 2022)

*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 July 1, 2022 through September 30, 2022.

This quarter, the SEC proposed five new rules and approved six final rules. In comparison to last quarter, the SEC has doubled the number of final rules while remaining generally consistent with the number of proposed new rules for the quarter. Based on the SEC's Investor Advisory Committee public meeting held near the end of this quarter, it appears that the SEC is considering taking more definitive action on its proposed rule revisions regarding human capital management and labor valuation and performance, Schedule 13D and 13G beneficial ownership reports, climate disclosures and cybersecurity disclosure.

Final Rules

Executive Pay Versus Performance

Overview of Final Rule

On August 25, 2022, the SEC adopted final rules implementing pay versus performance disclosure requirements. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was signed into law in July 2010, the SEC was directed to adopt rules requiring a registrant to disclose the relationship between executive compensation and the registrant's financial performance.

The final rules mandate that proxy statements or information statements for which the inclusion of executive compensation disclosure is required include a new compensation table that

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describes the following for each of the five most recently completed fiscal years:

1. the "executive compensation actually paid" (as described further below) to the registrant's principal executive officer ("PEO") and the average of such amounts for the registrant's other named executive officers ("NEOs");
2. total compensation as disclosed in the Summary Compensation Table for the PEO and the average of such amounts for the other NEOs;
3. total shareholder return;
4. peer group total shareholder return, which must be the same index or peer group used for the purposes of the stock price performance graph required under Item 201(e) of Regulation S-K or, if applicable, the peer group used for purposes of the Compensation Discussion and Analysis disclosures;
5. net income; and
6. a registrant-selected financial measure ("Company-Selected Measure") that represents the most important financial measure used by the registrant to link compensation actually paid to the registrant's performance.

An example of the table to be incorporated in proxy statements and information statements is provided below:

Year (a)	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for non-PEO NEOs (d)	Average Compensation Actually Paid to non-PEO NEOs (e)	Value of Initial Fixed $100 Investment Based On:		Net Income (h)	[Company-Selected Measure] (i)
					Total Shareholder Return (f)	Peer Group Total Shareholder Return (g)		
Y1								
Y2								
Y3								
Y4								
Y5								

In addition to the table outlined above, a registrant will need to provide a clear description of the relationships between each of the financial performance measures included in the table and the executive compensation actually paid to its PEO and the average of such amounts to its other NEOs. The registrant is also required to include a description of the relationship between the registrant's total shareholder return and its peer group total shareholder return.

The final rules also require a registrant to provide a list of three to seven financial performance measures that the registrant determines are its most important measures used to determine

the link between the executive compensation actually paid and the registrant's performance for the most recent fiscal year. If there are at least three financial performance measures, the registrant may also include non-financial performance measures in the list. However, if there are fewer than three financial performance measures listed, then the registrant must include all measures used to determine the link between executive compensation actually paid and the registrant's performance.

Executive Compensation Actually Paid

The final rule defines the term "executive compensation actually paid" as the total compensation reported in the Summary Compensation Table with certain adjustments made to the amounts reported for pension values and equity awards. While it purports to cover compensation "actually paid," this defined term in fact captures both compensation paid or earned, as well as incremental accounting valuations for unvested equity awards that may never be earned or could have different intrinsic values when earned. To reconcile the ambiguity, the defined term provides for adjustment to pension values and equity awards pursuant to a formula described below.

The adjustment formulae have multiple steps:

- To calculate the pension value when determining the executive compensation actually paid, start with the total value in the Summary Compensation Table for the applicable year. Then, subtract the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans. Then, add service costs for services rendered by the PEO or NEOs during the applicable year calculated in accordance with generally accepted accounting principles ("GAAP") and then add the entire cost of benefits granted in a plan amendment (or initial plan) during the applicable year that are attributed by the benefit formula to services rendered in periods prior to the plan amendment or adoption (the "prior service cost") calculated in accordance with GAAP. If the prior service cost is a negative amount as a result of an amendment that reduces benefits relating to prior periods of service, then such amount would reduce the compensation actually paid.
- To calculate the equity awards when determining with the executive compensation actually paid, start with the total value in the Summary Compensation Table for the applicable year. Then, subtract the amounts reported in the Summary Compensation Table for equity awards. For awards granted in the covered fiscal year, add the year-end fair value if the award is outstanding and unvested as of the

end of the covered fiscal year, then add the fair value as of the vesting date for awards that vested during the covered fiscal year, and then, if applicable, ignore any such awards that were forfeited or determined to be ineligible to vest during the covered fiscal year. For awards granted in prior years, add or subtract any change in fair value as of the end of the covered fiscal year (compared to the end of the prior fiscal year) if the award is outstanding and unvested as of the end of the covered fiscal year, then add or subtract any change in fair value as of the vesting date (compared to the end of the prior fiscal year) if the award vested during the covered fiscal year, and then subtract the amount equal to the fair value at the end of the prior fiscal year if the award was forfeited during the covered fiscal year. After making those calculations described above for equity awards, then add the dollar value of any dividends or other earnings paid on equity awards in the covered fiscal year prior to the vesting date.

These adjustments must be disclosed in footnotes to the columns in the table showing compensation actually paid. Registrants will also be required to disclose in footnotes any valuation assumptions that are materially different from those disclosed at the time of grant of such equity awards. Smaller reporting companies are not required to disclose amounts related to pension benefits for purposes of calculating compensation actually paid.

Registrants Subject to Final Rule and Compliance Periods

The final rule goes into effect on October 11, 2022. Registrants that are subject to the final rules must comply with these new disclosure requirements by providing such disclosures in their proxy statements and information statements that cover fiscal years ending on or after December 16, 2022.

The final rules require these disclosures for all registrants other than emerging growth companies, foreign private issuers and registered investment companies. Registrants, other than smaller reporting companies, will be subject to a transition period whereby such registrants are required to provide disclosure of at least the three most recent years in its first proxy statement or information statement in which they provide the pay versus performance disclosure, then adding another year of disclosure in each of the two subsequent years.

Smaller reporting companies are subject to scaled disclosure requirements compared to the other registrants that must comply with the final rules. Smaller reporting companies are not required to provide peer group total shareholder return or any Company-

Selected Measures. Also, as noted above, smaller reporting companies may exclude the amounts relating to pension values when calculating the executive compensation actually paid.

Initially, smaller reporting companies are required to provide disclosure for at least the two most recent years in their first proxy statement or information statement in which they provide the pay versus performance disclosure, then adding another year of disclosure in the subsequent year. Finally, smaller reporting companies are also afforded a transition period to file Inline XBRL data. Smaller reporting companies are required to begin providing Inline XBRL data beginning with the third filing in which they provide pay versus performance disclosure.

In general, the pay versus performance disclosures are only required for fiscal years in which the registrant was a reporting company. The pay versus performance disclosures required pursuant to this final rule will be treated as "filed" for the purposes of the 1934 Act and will be subject to the say-on-pay advisory vote under 1934 Act Rule 14a-21(a).

Impact on Registrants

This final rule will require an extensive amount of time to compile the calculations and the necessary disclosures. Registrants that have a fiscal year ending December 31 will be required to provide these new pay versus performance disclosures in their 2023 proxy statement, and for such registrants, other than smaller reporting companies, the 2023 proxy statement will need to cover the 2022, 2021 and 2020 fiscal years. Given the anticipated amount of time and work that will be required to comply with this final rule, registrants that must disclose this information in their 2023 proxy statement should start preparing their disclosures and the table.

Proxy Voting Advice

In July 2020, the SEC adopted final rules (the "2020 Final Rules") regarding proxy voting advice given by proxy advisory firms, or "proxy voting advice businesses" (the "PVABs"). The 2020 Final Rules codified the SEC's interpretation that proxy voting advice generally constitutes a "solicitation" subject to the proxy rules. The 2020 Final Rules also introduced two new conditions that PVABs need to meet in order to avoid being subject to information and filing requirements under applicable proxy rules. These conditions include (1) an enhanced conflict of interests disclosure and (2) the adoption and public disclosure of written policies and procedures reasonably designed to ensure that (i) companies have PVABs' advice available to them at or prior to the time such advice is disseminated to the PVABs' clients and

(ii) PVABs provide their clients with a mechanism by which they can be timely notified of any written statements by a company regarding the proxy voting advice before the shareholder meeting. The 2020 Final Rules also added note (e) to Rule 14-9, which prohibits false or misleading statements, to include examples of material misstatements or omissions related to proxy voting advice ("Note (e)").

The 2020 Final Rules were intended to help ensure that investors who use proxy voting advice receive more transparent, accurate, and complete information on which to make their voting decisions. However, after the SEC adopted the 2020 Final Rules, institutional investors and other PVABs' clients continued to express strong concerns about the rules' impact on their ability to receive independent proxy voting advice in a timely manner. In response, the SEC decided to reassess the 2020 Final Rules and recalibrate the rules to address the concerns of investors and PVABs' clients.

In July 2022, the SEC released final rules that amended the 2020 Final Rules (the "2022 Final Rules"). The 2022 Final Rules eliminate the requirement that PVABs adopt and disclose written policies and procedures reasonably designed to ensure that conditions (i) and (ii) above are met. The SEC explained that PVABs serve a crucial role in the proxy process and their clients should receive proxy voting advice in a timely manner. Conditions (i) and (ii) that were introduced in 2020 were intended to benefit PVABs' clients and the underlying investors they serve. However, many investors and PVABs' clients found that these conditions actually impaired the independence and timeliness of proxy voting advice without corresponding investor protection benefits. As investor protection has always been the main touchstone of the SEC's rulemaking effort, and in light of the strong opposition from those the rules were intended to serve, the SEC decided to rescind those conditions to minimize any burden that PVABs and their clients were experiencing. In rescinding these conditions, the SEC recognizes that the rescission may cause concerns as to companies' ability to address errors in or disagreements with proxy voting advice. However, the SEC believes that the potential benefits of conditions (i) and (ii) do not justify the risk they pose.

The 2022 Final Rules also eliminate Note (e) as the SEC determined that Note (e) creates confusion regarding the application of Rule 14a-9 to proxy voting advice. For example, unlike the other paragraphs of the notes which apply to all types of solicitation, Note (e) concerns a particular type of solicitation, the provision of proxy voting advice. The SEC's current belief is that drawing this distinction would be counterproductive and create interpretative challenges under Rule 14a-9.

The 2022 Final Rules do not change the 2020 Final Rules' codification that proxy voting advice constitutes a "solicitation" subject to the proxy rules. The new rules also do not change the enhanced conflict of interests disclosure required under the 2020 Final Rules. As a result, under the 2022 Final Rules, proxy voting advice remains a solicitation subject to the federal proxy rules, and PVABs remain subject to the enhanced conflicts of interest disclosures.

Despite certain aspects of the 2020 Final Rules remaining unaffected by the 2022 Final Rules, many critics, including SEC Commissioner Hester Peirce, have vocalized their concerns about the 2022 Final Rules, noting that the SEC rescinded rules that were adopted less than two years ago and arguably without substantial justification. These critics claimed that the SEC's amendments to and rescissions of recently adopted policies could potentially confuse market participants. In addition, the recent reversal raises concern as to the SEC's power and authority. As a result, the 2022 Final Rules are being challenged in court in two separate cases, with both cases alleging that the SEC has exceeded its authority and failed to follow the appropriate federal process for policy revision.

The 2022 amendments and rescissions to provisions of the 2020 Final Rules went into effect on September 19, 2022.

Whistleblower Rule

The SEC adopted final amendments to the rules implementing the SEC's whistleblower program, reversing certain modifications made to the program under previous SEC Chair Jay Clayton. The previously existing rules permitted the SEC to decrease awards made to whistleblowers when the tips led to actions by agencies other than the SEC.

Exchange Act Rule 21F sets out the regulatory framework for the handling of whistleblower complaints. The whistleblower program was adopted pursuant to the Dodd-Frank Act as an incentive to alert the SEC to ongoing securities laws violations. Existing rules permit a whistleblower's tip to lead to recovery under both an SEC enforcement action and a non-SEC judicial or administrative action. However, Rule 21F-3 establishes criteria limiting the right to receive multiple recoveries for the same tip from both the SEC and other related governmental authorities.

The SEC had proposed to adopt what it terms the "Comparability Approach" to analyzing multiple recoveries in order to maintain a strong incentive for whistleblowers to come forward. Under this approach, the SEC may treat a non-SEC action as related (and therefore entitled to multiple recovery) if the maximum potential monetary award from the alternative award program

would be “meaningfully smaller” than the maximum potential award from the SEC, if the maximum total award amount that the SEC could pay is less than or equal to $5 million, or if recovery under the alternate award program is purely discretionary. The SEC adopted the Comparability Approach in its final rules. In addition, the SEC revised Rule 21F-6 to limit the SEC’s discretionary authority over the amount of a whistleblower award such that the SEC may only exercise discretion to increase an award, not to decrease it.

Some argued that the rule changes to make the whistleblower regime potentially more lucrative were not necessary given that 2021 was a record year for the program, with $564 million in awards made to 108 recipients, a substantial increase over the $175 million of awards made in fiscal year 2020. However, while the SEC admitted that the effect of the new rules will be slight, they believe that the improved incentives will “have a positive effect on the frequency of whistleblowing activity.”

The amendments will become effective on October 3, 2022 and will apply to any whistleblower award application that is pending as of that date, and to all future-filed award applications.

Proposed Rules

Exemption from National Securities Association Membership

In 2015, the SEC proposed to amend Rule 15b9-1 under the 1934 Act to require broker-dealers trading in off-exchange venues to become members of a national securities association. However, the SEC did not adopt its 2015 rule proposal. Even though the SEC did not adopt the proposed rule, the SEC remained concerned that proprietary trading dealer firms’ reliance on the exemption from Section 15(b)(8) of the 1934 Act would undermine the effectiveness of a self-regulatory organization’s regulatory structure and oversight of the securities markets. Thus, on July 29, 2022, the SEC re-proposed very similar rules to the 2015 proposal. This new proposed rule would narrow the current exemption under Section 15(b)(8) of the 1934 Act by requiring any broker-dealers registered with the SEC to become a member of a national securities association if such broker-dealer effects securities transactions other than on an exchange of which it is a member, unless the exemptions described below apply. At this time, the Financial Industry Regulatory Authority (“FINRA”) is the only registered national securities association.

Currently, 1934 Act Rule 15b9-1 provides an exemption from Section 15(b)(8) of the 1934 Act under which certain SEC-registered dealers may engage in unlimited proprietary trading

of securities on any national securities exchange of which they are not a member or in the over-the-counter market without triggering Section 15(b)(8)'s FINRA membership requirement.

This proposed rule narrows the scope of the current exemption as it would require a broker-dealer to join FINRA if it effects securities transactions other than on an exchange of which it is a member, unless such broker-dealer:

1. is a member of a national securities exchange;
2. carries no customer accounts; and
3. engages in such transactions that (a) result solely from orders that are routed by a national securities exchange of which the broker-dealer is a member to comply with Rule 611 of Regulation NMS or the Options Order Protection and Locked/Crossed Market Plan or (b) are solely for the purpose of executing the stock leg of a stock-option order.

The SEC dramatically narrowed the current exemption in this proposed rule as it applies to off-exchange trading. Given that most broker-dealers effect transactions on multiple exchanges, not just the national securities exchange in which they are a member, broker-dealers would not be able to satisfy the applicable exceptions under the proposed rule. In essence, this proposed rule would require many broker-dealers to join FINRA if such broker-dealer cannot satisfy the exceptions described above.

The SEC believes that this proposed rule would modernize and improve market oversight because more broker-dealers would be subject to FINRA oversight. The SEC believes this would strengthen oversight over firms that trade securities across several markets, helping to protect investors and to maintain fair, orderly and efficient markets. Comments regarding the proposed rules are due by September 27, 2022.

Substantial Implementation, Duplication, and Resubmission of Shareholder Proposals under Exchange Act Rule 14a-8

To facilitate shareholders' rights to present their proposals at shareholder meetings, Rule 14a-8 under the 1934 Act requires companies that are subject to the federal proxy rules to include shareholder proposals in their proxy statements to shareholders unless the proposal is properly excluded under the rule's listed exclusions. Since the adoption of Rule 14a-8, the SEC has amended Rule 14a-8 on numerous occasions in an effort to improve the operation of the shareholder proposal process. The most recent proposal would amend three of the rule's substantive bases for exclusion: (i) Rule 14a-8(i)(10) on substantial implementation, (ii) Rule 14a-8(i)(11) on duplication and (iii) Rule 14a-

8(i)(12) on resubmission. The comment period expired on September 12, 2022.

Rule 14a-8(i)(10)—Substantial Implementation

Currently, the substantial implementation exclusion permits a company to exclude shareholders' proposals that the company has already substantially implemented. Given the lack of specificity, the SEC proposes to amend its "substantially implemented" standard to clarify that a proposal may be excluded if "the company has already implemented the essential elements of the proposal." The SEC believes that an analysis that focuses on the proposal's essential elements would provide a more reliable indication of whether the actions taken to implement the proposal are sufficiently responsive such that the proposal has been substantially implemented and may be excluded. The SEC acknowledges that determining whether a proposal could be excluded under their proposed "essential elements" standard may lead to some subjectivity such as deciding which elements of the proposal should be deemed "essential elements." However, the SEC anticipates that the degree of specificity of the proposal and its stated primary objective will help guide the analysis. In proposing this new standard, the SEC makes clear that a proposal need not be fully implemented in exactly the way the proponent desires for it to be excluded. A company may be permitted to exclude a proposal if the differences between the proposal and the company's actions are not essential to the proposal.

Rule 14a-8(i)(11)—Duplication

The duplication exclusion allows a company to exclude shareholder proposals that substantially duplicate another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting. However, the SEC finds that the current standard unintentionally creates an "umbrella effect" in which the duplication exclusion could be used to omit proposals that had only a vague relation to the subject matter in a prior proposal. The SEC's proposed amendment to the duplication exclusion would avoid this consequence by specifying that a proposal substantially duplicates another proposal if it "addresses the same subject matter and seeks the same objective by the same means." By providing for exclusion only where a proposal "addresses the same subject matter and seeks the same objective by the same means," the proposed amendment would alleviate the potential "umbrella effect" and make it more difficult for companies to exclude multiple shareholder proposals that address a similar concern but with a different objective or plan.

Rule 14a-8(i)(12)—Resubmission

The resubmission exclusion allows a company to exclude a shareholder proposal that addresses substantially the same subject matter as a proposal previously included in the company's proxy materials within the preceding five calendar years if the matter was voted on at least once in the last three years and did not receive at least (i) 5% of the votes cast if previously voted on once; (ii) 15% of the votes cast if previously voted on twice; or (iii) 25% of the votes cast if previously voted on three or more times. The SEC is concerned that the current "substantially the same subject matter" test unduly constrains shareholders' suffrage because it fails to account for different approaches to the same or similar issue. The SEC proposed to amend the resubmission exclusion to provide that a shareholder proposal will be considered a "resubmission" if the proposal "substantially duplicates" a proposal previously included in a company's proxy materials. This proposed amendment would align the "resubmission" standard with the "duplication" standard under Rule 14a-8(i)(11).

Conclusion

The SEC believes that the proposed amendments would improve the shareholder proposal process based on modern developments and the SEC's observations over the years. The proposed amendments would facilitate shareholders' suffrage and improve communication between the shareholders and their companies by promoting more consistent and predictable determination. By providing greater certainty and transparency with respect to the standard to be applied, the proposed amendments would assist shareholder-proponent in drafting their proposals and companies in determining whether a proposal may be excluded under the rule. Despite the SEC's optimistic view on these proposed amendments, Nasdaq, Inc. submitted a comment letter noting that the SEC new proposals could be a step backwards in the SEC's effort to modernize the shareholder proposal process because these new proposals narrow the bases for excluding shareholder proposals.

SEC Strategic Plan 2022–2026

On August 24, 2022, the SEC released its new draft strategic plan setting out the Commission's high level objectives for the fiscal years 2022 through 2026. The draft release provides valuable insight into the staff's medium-term rulemaking and enforcement priorities.

The SEC lists three goals:

1. protect working families against fraud, manipulation, and misconduct;

2. develop and implement a robust regulatory framework that keeps pace with evolving markets, business models and technologies; and
3. support a skilled workforce that is diverse, equitable, and inclusive and is fully equipped to advance agency objectives.

The release states a desire to enforce the law "aggressively and consistently," using new methods and increasing vigilance adapted to the challenges raised by "evolving technologies." The SEC identifies "the rapid growth in crypto assets" as one evolving risk in the market that will require greater scrutiny. The release also notes that the SEC will tailor its enforcement to the "economic realities of a given product or arrangement to determine whether it complies with securities laws," indicating that the staff will likely look through interpretations of securities laws that attempt to evade regulation. This approach aligns with recent statements from Chair Gensler, who stated that the "vast majority" of crypto tokens are securities subject to the securities laws and SEC jurisdiction.[1] The SEC recognizes that it needs to get smarter on the crypto market and hints that it may also "pursue new authorities from Congress" to help it respond to evolving capital markets.

The strategic plan places an emphasis on enhancing the SEC's technology and facility with data. Investment in data analytics in furtherance of enforcement dovetails with the SEC's aim under Goal 3 to move "aggressively to the cloud, remaking its technology environment to optimize capabilities, costs, resilience, and security for the agency as a whole." As a subsidiary aim of Goal 1, the SEC intends to use a more data-driven approach "to surveil the markets, promote competition, and enforce the law." The SEC is also keenly concerned with cybersecurity risks, both to the agency itself and to issuers and investors. It appears that the SEC may take further steps on cybersecurity matters to safeguard investors even after proposing a new item to Form 8-K mandating disclosure of certain material cybersecurity breaches. Moreover, by referring to "working families" throughout the release, the SEC signals that it intends to focus rulemaking and enforcement on protecting retail investors. As part of that focus, the SEC intends to continue to improve disclosure that it believes investors crave on issues such as climate risk and human capital, and improve access to public disclosure for investors.

The SEC also calls for increased coordination with foreign financial regulators, and evinces a concern that some "new entrants to U.S. markets seek to avoid or evade U.S. securities laws." Already, U.S. regulators have made progress on this front with the August 27, 2022 Statement of Protocol Agreement between the PCAOB and China, providing a framework for the

PCAOB to conduct inspections of registered public accounting firms located in China and Hong Kong. In a statement, Chair Gensler applauded the new agreement, but noted that the "framework is merely a step in the process" and that the agreement will only prove meaningful if it indeed provides access to the PCAOB that has heretofore been rejected by Chinese authorities.[2] The SEC views access to U.S. markets as privilege and has stressed that foreign issuers who want access must accept a level playing field with U.S. firms.

Despite the change in presidential administrations and the consequent shift in the balance of power at the SEC, the 2022–2026 strategic plan has a relatively high degree of continuity with the SEC's previous strategic plan. Both documents speak to the concerns of retail investors, the need to keep up with evolving capital markets and the desire to strengthen the SEC's human capital and data resources, though there are some subtle changes in emphasis. It will be interesting to see how forthcoming SEC rulemaking and enforcement shapes the pursuit of the SEC's strategic objectives over the next several years.

Second Circuit Affirms Southern District of New York's Decision Not To Revisit SEC's "Scheme Liability" Case

On July 15, 2022, the Second Circuit affirmed Southern District of New York's ("SDNY") dismissal of an action brought by the SEC against Rio Tinto plc and Rio Tinto Limited (together, the "Company") for alleged violations of Section 10(b) of the Securities Exchange Act and sections 17(a)(1) and (3) of the Securities Act.

Beginning in April 2011, the Company purchased a coal mine in Mozambique for $3.7 billion, based on the assumption that the mine would produce sufficient coal. The Company subsequently learned that the coal was of poor quality and the cost to transport the coal would cost more than five times the cost of the mine itself. In May 2012, the Company's executives learned the net present value of the mine was negative $680 million. The Company issued financial statements and prepared auditing papers that the SEC alleged failed to disclose the mine's negative valuation. The mine was ultimately sold in October 2014 for $50 million.

The SEC alleged scheme liability as to information provided by the Company to its Audit Committee and auditors. In 2019, the SDNY dismissed the SEC's scheme liability claims following *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005), on the basis that the alleged conduct was misstatements and omissions only. Around one week later, the United State Supreme Court

decided *Lorenzo v. SEC*, 139 S. Ct. 1094 (2019). *Lorenzo*, in part, held that an individual could be held liable under scheme liability if that person disseminated a false statement, even if they were not the maker of the statement. The SEC in *Rio Tinto* sought reconsideration on its allegations of scheme liability in light of *Lorenzo*; the SDNY declined to reconsider.

On appeal, the Second Circuit decided "whether misstatements and omissions—without more—can support scheme liability" pursuant to Rule 10b-5 and Sections 17(a)(1) and (3)." The Court held "misstatements and omissions can form *part* of a scheme liability claim, but an actionable scheme liability claim also requires something *beyond* misstatements and omissions, such as dissemination." (Decision at 5) (emphasis in original). The Court reasoned that scheme liability premised only on misstatements and omissions would swallow up the misstatement liability provisions within 10b-5 and Section 17(a)(1). The Court agreed with the SDNY that there needed to be another deceptive act, separate from the alleged misstatement. Therefore, dissemination is an example of the "something more."

The Court also considered the practical impact that scheme liability premised on misstatements, where the defendant is not alleged to have made the statement, circumvents the heightened pleading standard of the PSLRA.

SEC v. Rio Tinto PLC et al., (2d Cir. No. 21-2042) decision available at https://www.law360.com/articles/1511994/attachments/0.

Central District of California Denies Motion to Dismiss Against The Honest Company

On July 18, 2022, the Central District of California, Judge Mark Scarsi, denied The Honest Company's (the "Company") and its officers and directors (collectively with the Company, the "Defendants") motion to dismiss a putative securities class action alleging the Company violated Section 11 of the Securities Exchange Act of 1934 by making false and misleading statements concerning consumer demand.

The Company is a "clean lifestyle" baby and healthcare brand (notably founded by actress Jessica Alba). The Company held an initial public offering ("IPO") in May 2021. Lead Plaintiff claims that the Company made misleading statements in its registration statement by failing to disclose the negative impacts and potential risks the Company might face due to (1) negative consumer reviews about a diaper product and (2) that consumers had stocked up on the Company's products due to the COVID-19 pandemic. Lead Plaintiff alleges that at the time of the IPO, the Company knew that multi-million dollar demand from the pandemic would rapidly decrease.

With respect to the negative reviews about the Company's "Clean Conscious Diaper," Lead Plaintiff alleges that the Company failed to disclose or materially omitted that customers said the diaper was not safe or effective, that the diaper was not "achieving the pillars" of the Company's strategy which promotes safety and sustainability, and that the Company lost customers and revenue due to the displeasure for the diapers. The Court disagreed with each of the Company's arguments, such as implausibility and mere corporate puffery, and held "Lead Plaintiff adequately tethers customers' efficacy and safety concerns with the Clean Conscious Diaper to statements and omissions in the offering documents."

With respect to consumers stockpiling the Company's products, Lead Plaintiff alleges the Company touted increased demand while failing to disclose that sales were actually decreasing, that the Company had daily reports of inventory, and that the stockpiling occurred months before the IPO. The Court held that Lead Plaintiff adequately plead its theory that the Company knew at the time of the IPO that consumer demand for products would decline, and in fact knew it was already declining.

In re The Honest Company Securities Litigation, No. 2:21-cv-07405-MCS-PLA (C.D. Cal. Jul. 18, 2022) available here: https://www.law360.com/articles/1513535/attachments/0.

NOTES:

[1] https://www.sec.gov/news/speech/gensler-sec-speaks-090822.

[2] https://www.sec.gov/news/statement/gensler-audit-firms-china-hong-kong-20220826.