Securities Regulation Law Journal

Volume 44 Number 4 Winter 2016

THOMSON REUTERS

Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (July 1, 2016 - September 30, 2016)

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This issue's Survey focuses on the U.S. Securities and Exchange Commission's ("SEC") rulemaking activities and major Federal Appellate or 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, 2016 through September 30, 2016.

SEC Approves Proposed Rules by FINRA to Establish "Pay-to-Play"

On August 25, 2016, the SEC approved both FINRA (Financial Industry Regulatory Authority, Inc.) Rule 2030 and FINRA Rule 4580, initially proposed on December 16, 2015. The Rules were filed pursuant to Section 19(b)(1) of the 1934 Act and impose "pay-to-play" restrictions and recordkeeping requirements on broker-dealers that act as placement agents for investment advisers. **(See Release No. 34-78683)**

Under Rule 2030, covered members will be prohibited from engaging in distribution or solicitation activities with a government entity on behalf of an investment adviser that provides advisory services to such government entity within two years after a contribution is made. A covered member is defined as a member firm that "solicits a government entity on behalf of an affiliated investment adviser." Additionally, a covered associate is prohibited from making a contribution to an official government entity with which the covered member is engaging in solicitation activities on behalf of an investment adviser. Similarly, a person who becomes a covered associate is prohibited from making a contribution to an official of the government entity for two years, upon becoming a covered associate. A covered associate includes any person who engages in distribution or solicitation activities with a government entity or any general partner, managing member or executive officer of a covered member. The two-year "cooling-off period" is intended to deter covered members from participat-

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ing in "pay-to-play," due to the diminishing effect of a political contribution made more than two years ago.

Under Rule 4580, covered members that engage with government entities pursuant to Rule 2030 are required to maintain books and records subject to FINRA inspection.

The final rules go into effect October 31, 2016.

SEC Adopts Amendments to Form ADV and Investment Advisers Act Record Keeping Rule 204-2

On August 25, 2016, the SEC adopted final amendments to Rule 204-2 of the Investment Advisers Act of 1940 (the "Advisers Act") as well as amendments to Part 1A of Form ADV. Generally, the amendments seek to improve the quality of information provided to investors and enhance the SEC's ability to regulate the asset management industry. **(See Release No. IA-4509)**

Among other items, the amendments to Part 1A of Form ADV require advisers to provide information on separately managed accounts and standardize the process of "umbrella" registration of private fund advisers into one Form ADV. In Part 1A of Form ADV, advisers will be required to report the percentage of regulatory assets under management for their separately managed accounts for 12 broad categories, compared to the 10 categories initially proposed. By standardizing the process, the SEC hopes that "umbrella" registration will simplify the registration requirements for an adviser that registers multiple affiliated private fund investment advisers.

In addition, the amendments to the Advisers Act will change Rule 204-2, and require advisers to maintain books and records related to their performance, to help deter fraudulent performance claims in written communications to clients and in its advertising.

The final rules go into effect October 31, 2016.

SEC Adopts Final Rule for Reporting and Dissemination of Security-Based Swap Information

On July 14, 2016, the SEC adopted new rules and final amendments to certain provisions of Regulation SBSR, which concerns the reporting to the SEC and public dissemination of information regarding security-based swaps. The new rules focus on transparency through enhanced regulation of the reporting of security-based swap ("SBS") transactions. **(See Release No. 34-78321)**

Under new Rule 901(a)(1), national securities exchanges or SBS execution facilities must report any swap executed on the platform that will be submitted to clearing. Correspondingly, under new Rule 901(a)(2)(i), a registered clearing agency must report any SBS for which it is a counterparty.

Additionally, the SEC adopted amendments that would (i) prohibit registered SBS data repositories from imposing fees and restrictions on transaction data required to be publicly disseminated and (ii) require any cross-border SBS transaction to be reported to the SEC and publicly disseminated.

The final rules go into effect October 11, 2016.

SEC Adopts Final Rule for SBS Data Depositories

On August 29, 2016, the SEC adopted amendments to Rule 13n-4 under the 1934 Act regarding access to SBS data held by SBS data repositories pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Under the new rules, SBS data repositories would be required to make their data available to certain regulators and other authorities. **(See Release No. 34-78716).**

The new rules become effective 60 days after the date of publication in the Federal Register.

SEC Approves FINRA Rule for Capital Acquisition Brokers

On August 19, 2016, the SEC approved FINRA's proposed rule change to SR-FINRA-2015-054, initially filed on December 4, 2015, pursuant to Section 19(b)(1) of the 1934 Act. The rule will allow certain corporate financing activities by capital acquisition brokers ("CAB") to elect to operate under a more limited FINRA rule set. The designation of a CAB applies to broker-dealers conducting private fund placement services, corporate finance or investment banking advisory activities. **(See Release 34-78617).**

Registration to become a CAB is voluntary and depends on whether the registrant is currently a FINRA member. CAB applicants that are not FINRA members will need to file a FINRA New Membership Application, while current FINRA members must amend their membership agreement to limit activities to those permitted for CABs.

Although the CAB rules incorporate standard FINRA member rules ("FINRA rules"), the CAB rule set is less stringent than the FINRA rules governing broker-dealers. The CAB rules permit predictions or projections of performance in communications sent to prospective investors and provide reduced compliance responsibilities. Despite these differences, every CAB, like any broker-dealer, must be in compliance with net capital requirements set forth in Rule 15c3-1 of the 1934 Act, and debt must not exceed 1500% of its net capital.

The implementation date for the rules will be announced in a regulatory notice published shortly. The implementation date will be no later than 180 days after publication of the regulatory notice.

SEC Adopts Final Rule on Standards for Covered Clearing Agencies

On September 28, 2016, the SEC adopted final amendments to Rule 17Ad-22 and added new Rule 17Ab2-2 pursuant to Section 17A of the 1934 Act and the Payment, Clearing, and Settlement Supervision Act of 2010, under the Dodd-Frank Act. The rules will enhance standards for the operation of certain clearing agencies that meet the definition of "covered clearing agency." **(See Release No. 34-78961)**

Pursuant to existing Rule 17Ad-22, a covered clearing agency is defined as a registered clearing agency that "has been designated as systematically important by the Financial Stability Oversight Council . . . or provides central counterparty services for security-based swaps." The amendment adds a new provision (e) to existing Rule 17Ad-22, regarding operation criteria for covered clearing agencies. As amended, the Rule requires covered clearing agencies to: (i) maintain sufficient financial resources to cover its credit exposure; (ii) limit the assets it accepts as collateral to those with low credit, liquidity and market risks; (iii) establish a risk-based margin system to cover its credit exposure; (iv) establish, implement, maintain and enforce written policies to address risk management framework for managing legal, credit, operational, investment and other risks that may arise and (v) publicly disclose relevant data on transaction volume and values.

The final rule will be effective 60 days after publication in the Federal Register. The compliance date will be 180 days after publication in the Federal Register.

SEC Proposes Amendments to Disclosure on Institutional Orders

On July 13, 2016, the SEC proposed amendments to rules that would implement disclosures on institutional orders and expand the information included in existing retail order disclosures for broker-dealers currently set forth in Rules 600, 605, 606, and 607 of Regulation NMS under the 1934 Act. **(See Release No. 34-78309)**

Under the proposed rules, broker-dealers are required to provide customers with a disclosure report of institutional orders for that customer. The disclosure report would apply to orders with respect to exchange listed stocks having an original market value of at least $200,000. In addition, the report would include monthly data for the previous six months of institutional orders, detailed order handling information, and order routing strategies. Broker-dealers, on quarterly basis, would be required to make public, cumulative reports of all institutional orders.

The proposed rules also seek to enhance disclosures made by broker-dealers for retail orders. The new requirements would include, among other items: (i) more detailed information on payments received from, or paid to execution venues; (ii) an increase in reporting, from quarterly reports to monthly reporting; and (iii) separate reports for marketable and non-marketable limit orders.

Comments to the proposed rules were to be received on or before September 26, 2016.

SEC Proposes Rule to Update and Simplify Disclosure Requirements

On July 13, 2016, the SEC proposed amendments to certain disclosure requirements under Regulation S-K and Regulation S-X that have become redundant, outdated or superseded. The following amendments are part of the SEC's effort to simplify and modernize disclosure requirements. **(See Release No. 33-10110)**

Certain amendments proposed would remove requirements currently set forth in Regulation S-K and Regulation S-X that duplicate requirements under US Generally Accepted Accounting Principles ("US GAAP") or International Finance Reporting Standards ("IFRS") including, among other items, rules regarding foreign currency, income tax reconciliation, warrants, rights and convertible instruments, and related party transactions.

In addition, the SEC has identified several outdated requirements for disclosure including, but not limited to: high and low sale price's for an issuer's common stock; the provision of exchange rate data by foreign private issuers; and disclosure concerning the availability of filings at the SEC's Public Reference Room.

Comments to the proposed rules were due by November 2, 2016.

SEC Proposes Rule to Add Disclosure for Order Handling Information

On July 13, 2016, the SEC proposed to amend Rules 600 and 606 of Regulation NMS concerning national market systems. Under the proposed rules, broker-dealers would be required to provide additional disclosure to customers concerning the routing and execution of their orders. Broker-dealers would be required to make such information available to customers for each calendar quarter. **(Release No. 34-78309)**

Comments to the proposed rules were due by September 26, 2016.

Appellate and Other Decisions of Note

Supreme Court to Rule on Whether Pecuniary Gain is Necessary to Find Insider Trading

On October 5, 2016, the United States Supreme Court will hear oral argument on whether an insider receives a personal benefit by gifting confidential information to a family member, or whether the standard for personal benefit requires potential pecuniary gain.

As we reported in 43 Q. Surv. Sec Rulemaking 403 (2015), on July 6, 2015, the Court of Appeals for the Ninth Circuit affirmed the conviction of Bassam Salman, a remote tippee, holding that an insider receives a meaningful personal benefit from the tippee when a familial relationship exists between insider and tippee. Salman subsequently petitioned for a writ of certiorari, which the Supreme Court granted on January 19, 2016.

Under *Dirks v. S.E.C.*, 463 U.S. 646 (1983), a tippee of confidential information from an insider is liable for securities fraud, under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, when the insider has breached his fiduciary duty by disclosing the confidential information for personal gain, and the tippee knew the information was disclosed for the insider's personal benefit. The Government argues that, under *Dirks*, a personal benefit is realized "not only when the insider will reap a pecuniary gain from disclosure, but also when 'an insider makes a gift of confidential information to a trading relative or friend.' " Brief for the United States at 11, *United States v. Salman*, 136 S. Ct. 899 (2016) (No. 15-628) (quoting *Dirks*, 463 U.S. at 664). The Government maintains that "nothing justifies paring back [these] settled standards." *Id.* at 12.

According to defendant Salman, the standard is far from settled. He advances the narrow construction of "personal benefit" adopted by the Second Circuit in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), arguing that a pecuniary gain requirement comports with "judicial origins of the crime, due-process vagueness concerns, and the rule of lenity." Brief for Petitioner at 21, *United States v. Salman*, 136 S. Ct. 899 (2016) (No. 15-628). Specifically, Salman argues that the "Court's use of terms such as 'gain' synonymously with 'benefit,' and its focus on insiders who 'exploit' corporate information for 'profit' show that it was concerned with . . . insider tips for pecuniary gain." *Id.* at 29.

United States v. Salman, 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 136 S. Ct. 899 (2016).

Sixth Circuit Recognizes Alternative "Materialization of Risk" Theory, Reviving Rule 10b-5 Loss Causation Claim

On July 20, 2016, the Court of Appeals for the Sixth Circuit reversed and remanded the District Court's dismissal of a securities fraud action under Rule 10b-5 under the 1934 Act, finding that the Ohio Public Employees Retirement System ("OPERS") sufficiently alleged loss causation to survive a Rule 12(b)(6) motion to dismiss.

In January 2008, OPERS filed a securities fraud class action alleging "Freddie Mac violated §§ 10(b) and 20(a) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5." *Ohio Pub. Emp. Ret. Sys. v. Fed. Home Loan Mort. Corp.*, No. 14-4189, 2016 WL 3916011, at *4 (6th Cir. July 20, 2016). After unsuccessfully moving to dismiss OPERS' first, second, and third complaints, the District Court granted Freddie Mac's renewed motion to dismiss, finding OPERS failed to sufficiently plead loss causation. Loss causation, one of six requisite elements in a prima facie securities fraud action, "is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172 (2d Cir. 2005).

The Sixth Circuit previously acknowledged that loss causation may be demonstrated under the corrective disclosure theory. *See In re KBC Asset Mgmt. N.V.*, 572 Fed. Appx. 356, 360 (6th Cir. 2014). In reversing the District Court's decision, the Sixth Circuit recognized an alternative theory coined "materialization of the risk." Under this theory, loss causation can be established if "negative investor inferences . . . caused the loss and were a forseeable materialization of risk concealed by [a] fraudulent statement." *In re Omnicorp Grp., Inc. Sec. Litig.*, 597 F.3d 501, 511 (2d Cir. 2010). Application of this alternative theory permitted OPERS to successfully plead loss causation by alleging Freddie Mac's concealed subprime mortgage risks and later disclosure of a $2 billion loss foreseeably resulted in a 29% loss in stock price.

In recognizing this alternative theory, the Sixth Circuit noted "the dangerous incentive that is created when the success of any loss causation argument is made contingent upon a defendant's acknowledgement that it misled investors." *Ohio Pub. Emp. Ret. Sys.*, 2016 WL 3916011, at *7.

Ohio Pub. Emp. Ret. Sys. v. Fed. Home Loan Mort. Corp., No. 14-4189, 2016 WL 3916011 (6th Cir. July 20, 2016).

Seventh Circuit Reverses Approval of a "Disclosure Only" Settlement

On August 10, 2016, the Court of Appeals for the Seventh Circuit reversed the approval of a disclosure-only settlement in a shareholder suit alleging proxy statements relating to the Walgreens Co. and Alliance Boots GmbH merger violated Section 14(a) of the 1934 Act and Rule 14a-9 thereunder. The two-to-one circuit majority endorsed the legal standard promulgated by Delaware's Court of Chancery in *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016), holding that disclosure-only settlements in shareholder suits need "address a plainly material misrepresentation or omission." *In re Walgreens Stockholder Litig.*, No 15-3799, 2016 WL 4207962, at *4 (7th Cir. Aug. 10, 2016).

The settlement released Walgreens from liability for other disclosure claims and awarded class counsel $370,000 in attorneys' fees. In exchange, Walgreens provided six additional disclosures, comprised of less than 800 words in total. "Disclosures are meaningful only if they can be expected to affect the votes of a nontrivial fraction of the shareholders, implying that shareholders found the disclosures informative." Writing for the majority, Judge Richard Posner characterized the benefit of these brief disclosures as "nonexistent." "The type of class action illustrated by this case—the class action that yields fees for class counsel and nothing for the class—is no better than a racket."

In evaluating the disclosures, the District Court assessed whether they *may* have mattered to an investor. The Court's majority stated that the proper standard is not possibility, but probability—whether the disclosures *would be likely* to matter to a reasonable investor. "The district judge was handicapped by lack of guidance for judging the significance of the disclosure to which the parties had agreed in order to settle the class action at nominal cost to the defendant . . . and sweet fees for class counsel, who devoted less than a month to the litigation, a month's activity that produced no value."

The Circuit Court remanded the case, urging the District Court to seriously consider appointing new class counsel or dismissing the suit entirely. The majority appeared to suggest dismissal is the appropriate course of action, noting "the oddity of this case is the absence of any indication that members of the class have an interest in challenging the reorganization that has created Walgreens Boots Alliance."

In re Walgreens Stockholder Litig., No 15-3799, 2016 WL 4207962 (7th Cir. Aug. 10, 2016).

D.C. Circuit Finds SEC Administrative Courts Constitutional in First Appellate Ruling Regarding SEC Administrative Law Judge Appointments

On August 9, 2016, the Court of Appeals for the D.C. Circuit held the SEC's administrative courts constitutional, in the first Court of Appeals decision to address the merits of this constitutional challenge.

Raymond J. Lucia petitioned the D.C. Circuit to review a 2013 administrative law judge ("ALJ") decision finding violations of the Investment Advisers Act and imposing a lifetime industry ban. Petitioner argued that ALJs are Officers within the scope of the Appointments Clause, and that the ALJ who rendered the initial decision was unconstitutionally appointed.

The Appointments Clause dictates procedures for selecting Officers of the United States, including executive Officers, judicial Officers, and administrative agency Officers. Requisite to the determination of whether an ALJ is an Officer is the finality of ALJ decisions. The SEC retains the right to review any ALJ decision, though ALJ decisions may become final if SEC review is declined. Accordingly, the D.C. Circuit found ALJs do not issue final decisions on behalf of the SEC, and thus are not Officers subject to the Appointments Clause.

As we reported in 44 Q. Surv. Sec Rulemaking 306 (2016) and 43 Q. Surv. Sec Rulemaking 405 (2015), dozens of challenges to the constitutionality of ALJ appointments have flooded the Federal courts. On June 1, 2016, the Court of Appeals for the Second Circuit held that without an adverse ruling by both an ALJ and the full commission, subjects of SEC proceedings lack standing to challenge the proceedings' constitutionality in Federal court. *Tilton v. S.E.C.*, 824 F.3d 276 (2d Cir. 2016). On July 15, 2016, Lynn Tilton petitioned the full Second Circuit for a rehearing. Petitions in similar cases were filed in the Seventh and Eleventh Circuits.

Raymond J. Lucia Cos., Inc. v. S.E.C., No. 15-1345, 2016 WL 4191191 (D.C. Cir. Aug. 9, 2016).

See also Hill v. S.E.C., 825 F.3d 1236 (11th Cir. 2016).

See also Tilton v. S.E.C., 824 F.3d 276 (2d Cir. 2016).

See also Bebo v. S.E.C, 799 F.3d 765 (7th Cir. 2015), *cert. denied,* 136 S. Ct. 1500 (2016).

See also Jarkesy v. S.E.C., 803 F.3d 9 (D.C. Cir. 2015).

Ninth Circuit Finds Implicit Truthfulness Requirement in CEO and CFO Certifications, Reinstating SEC Enforcement Action Against Executives

On August 31, 2016, the Court of Appeals for the Ninth Circuit held Rule 13a-14 of the 1934 Act provides a cause of action against CEOs and CFOs who certify false or misleading financial reports. In so finding, the Ninth Circuit reinstated an SEC enforcement action against the former CEO and CFO of Basin Water, Inc. The SEC alleged that they defrauded investors by reporting millions of dollars in unrealized revenue.

All reports filed pursuant to Section 13(a) of the 1934 Act, such as form 10-Q and 10-K financial reports, require the issuer's principal executive and principal financial officer to sign a certification attesting to the accuracy of the financial disclosures. Rule 13a-14 was adopted in 2002, pursuant to Sarbanes-Oxley Act Section 302. Pursuant to Section 302, signing officers must certify that "based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading." 15 U.S.C.A. § 7421(a)(2).

The officers argued that Rule 13a-14 creates a cause of action against CEOs and CFOs who *fail* to sign or file certifications and that the rule "does not create a cause of action for filing *false* certifications independent of the existing provisions in the 1934 Act that prohibit fraudulent statements." The District Court for California agreed.

The Ninth Circuit reversed the District Court, defining for the first time the scope of Rule 13a-14. The Circuit Court noted that a signature is an attestation of accuracy. Accordingly, Rule 13a-14's signature requirement imparts "an implicit truthfulness requirement" as well. "It is not enough for CEOs and CFOs to sign their names to a document certifying that SEC filings include no material misstatements or omission without a sufficient basis to believe that the certification is accurate."

The Ninth Circuit has previously read an implicit truthfulness requirement into other rules promulgated under Section 13(a) of the 1934 Act. Addressing Rule 13a-13, in *Ponce v. S.E.C.*, 345 F.3d 722 (9th Cir. 2003), the Circuit Court held that quarterly report filings must not be misleading, though the text of the Rule merely states that reports must be filed without reference to the truthfulness of the content.

S.E.C. v. Jensen, No. 14-55221, 2016 WL 4537377 (9th Cir. Aug. 31, 2016).