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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (January 1, 2017-March 31, 2017)

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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 January 1, 2017 through March 31, 2017.

Congress and President Trump Overturn SEC Disclosure Rule

On February 14, 2017, President Trump signed an Act of Congress **(Pub L. No. 115-4, 131 Stat. 9 (2017))** overturning an SEC disclosure rule that called for oil, gas and mining companies to disclose certain payments pursuant to the 2010 Dodd-Frank Act. The Rule, adopted by the SEC **(See Release No. 34-78167)** under the Obama Administration, required those companies to publicly disclose payments of more than $100,000 (on an annual basis) made to the U.S. or foreign governments, in an effort to boost transparency in resource-rich countries. This action was enabled by the Congressional Review Act, which allows Congress to review and rescind a predecessor's recent regulations under certain circumstances. When first enacted, the U.S. oil industry argued that the Rule would put U.S. companies at a competitive disadvantage vis-à-vis foreign-owned extraction companies, some of which may not be subject to the disclosure rules.

SEC Shortens Securities Transaction Settlement Cycle

On March 22, 2017, the SEC adopted an amendment to Rule 15c6-1(a) under the 1934 Act to shorten the standard settlement cycle for most securities transactions effected through a broker-dealer from three business days to two business days. The three business days settlement cycle, known as T+3, was first introduced in 1993 and since then technology and the financial

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markets have evolved significantly. As such, the SEC believes that the current market warrants a two business day settlement cycle, now known as T+2. The amended Rule is designed to enhance efficiency, reduce risk and expedite the settlement process. **(See Release No. 34-80295)**

The amendment to Rule 15c6-1(a) restricts broker-dealers from purchasing or selling a security that would provide for payment or delivery of the security later than T+2, unless otherwise agreed to by the parties at the time of the transaction. The SEC has also stated that a further reduction to a one business day settlement cycle, or T+1, may have similar qualitative benefits of market, credit and liquidity risk reduction for market participants, as the T+2 settlement cycle. Accordingly, the SEC staff will continue to examine the impact of the T+2 settlement cycle and submit a report to the SEC no later than September 5, 2020.

The amendment will be effective 60 days after publication in the Federal Register, and broker-dealers will be required to comply with the amended rule on September 5, 2017.

SEC Proposes Amendments to Expand Municipal Securities Disclosure

On March 1, 2017, the SEC proposed amending Rule 15c2-12 under the 1934 Act to increase the list of events that trigger a notice requirement for issuers of municipal securities to the Municipal Securities Rulemaking Board (the "MSRB"), due 10 days from the event date. Such notice will be made available through the Electronic Municipal Market Access system (the "EMMA") which is the source for all municipal securities disclosures. The amendments to the Rule will improve access for investors to obtain the most current information about the financial obligations incurred by municipal issuers. **(See Release No. 34-80130)**

The proposed amendments would add the following to the list of events for which notice is required:

- Incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material; and
- Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties.

Issuers or other obligated persons already required to disclose certain events on Form 8-K should also consider whether any EMMA posting is required.

Comments to the proposed amendments required submission to the SEC on or before May 15, 2017.

Appellate and Other Decisions of Note

Ninth Circuit Finds Dodd-Frank Act Protects Internal Whistleblowers

On March 8, 2017, a divided Ninth Circuit held that the anti-retaliation protections of Section 21F of the 1934 Act extend to whistleblowers that internally report alleged unlawful activity, as well as those who report to the SEC.

In November 2014, Plaintiff Paul Somers sued former employer Digital Realty Trust, Inc. ("Digital Realty") alleging various violations of state and federal laws, including violations of Section 21F's anti-retaliation provisions. While an employee, Plaintiff reported possible securities violations to senior management, but he did not disclose the violations to the SEC. Digital Realty terminated Plaintiff's employment shortly thereafter. Digital Realty moved to dismiss Plaintiff's claim, arguing Section 21F protections extend only to whistleblowers that report to the SEC. The District Court denied the motion to dismiss and certified for interlocutory appeal whether Section 21F protects internal whistleblowers.

The Dodd-Frank Act added Section 21F to the 1934 Act to provide additional incentives and employment protections for whistleblowers. Section 21F defines a whistleblower as "any individual who provides, or two more individuals acting jointly who provide, information relating to a violation of the securities laws *to the Commission*." Though this definition captures only individuals who report information to the SEC, Plaintiff argued that later anti-retaliation subsections of Section 21F were intended to provide broad protections to individuals who make protected disclosures under the Sarbanes-Oxley Act. Specifically, subdivision (iii) provides: "No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower . . . in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002, this chapter, including section 78j-l(m) of this title, section 1513(e) of Title 18, and any other law, rule or regulation subject to the jurisdiction of the Commission."

The Ninth Circuit held that subdivision (iii) of Section 21F provides protections to individuals who report internally, as well as those who report directly to the SEC. The Court reasoned that applying the narrow definition of whistleblower to subdivision (iii) would constrict the protections "to the point of absurdity" and "all but read subdivision (iii) out of the statute."

The Ninth Circuit's holding deepens the divide between Circuits. In 2013, the Fifth Circuit held that only individuals who report to the SEC are whistleblowers within the meaning of Section 21F. *Asadi v. G.E. Energy (USA), L.L.C.*, 720 F.3d 620, 621 (5th Cir. 2013). In 2015, the Second Circuit found Section 21F ambiguous and deferred to the SEC's guidance as to the extent of its protections. *Berman v. Neo@Ogilvy LLC*, 801 F.3d 145, 155 (2d Cir. 2015).

Somers v. Digital Realty Trust Inc., 850 F.3d 1045 (9th Cir. 2017).

Supreme Court Denies Certiorari, Fraud-on-the-Market Theory Rebutted

On February 21, 2017, the United States Supreme Court declined to review the Second Circuit's dismissal of securities fraud claims by "value investors" brought under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder.

Plaintiffs—referred to as value investors—make their own determination as to the value of a publicly traded company's securities and endeavor to purchase such securities when the market price falls below their valuation. Plaintiffs invested in Defendants Vivendi Universal, S.A. and Vivendi S.A. between 2000 and 2002. Thereafter, Defendants' near-bankrupt state surfaced and the price of their securities dropped. In September 2009, Plaintiffs brought this securities fraud action in the District Court for the Southern District of New York, alleging Defendants made material misrepresentations regarding their liquidity risks.

To prevail on a Rule 10b-5 claim, a plaintiff must establish reliance upon a defendant's misrepresentations or omissions. Under the 'fraud-on-the-market' theory, a plaintiff may invoke a rebuttable presumption of reliance on the market price of traded shares. This theory assumes that the typical investor relies on the integrity of the market price—*i.e.,* that the market price reflects all public and material information. A defendant may rebut this presumption by "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price."

In February 2013, following a bench trial solely on the question of whether Defendants rebutted the fraud-on-the-market presumption of reliance, the District Court entered judgment for Defendants. The District Court found that Plaintiffs in fact relied on their internal metrics and not the integrity of the market. The District Court further found that Plaintiffs would have viewed Defendants as a more attractive investment had they fully disclosed their liquidity condition. On March 3, 2016, the Second

Circuit affirmed, finding Plaintiffs would have purchased Defendants' securities even if they had known of the alleged fraud.

Plaintiffs unsuccessfully petitioned the Supreme Court for writ of certiorari, arguing the District Court and Second Circuit applied the incorrect standard. Plaintiffs claimed that the presumption of reliance can only be rebutted if the investor would have paid the same prices in the same transactions had he known of the fraud.

GAMCO Inv'rs, Inc. v. Vivendi Universal, S.A., 927 F. Supp. 2d 88 (2d Cir. 2013), *cert. denied*, 137 S. Ct. 1104 (2017).

Government May Pursue "Gift Theory" in Pfizer Insider Trading Case

On February 10, 2017, the United States District Court for the Eastern District of New York denied Defendant Robert Schulman's motion to preclude the government from pursuing the "gift" theory of insider trading liability.

As reported in 45 Q. Surv. SEC Rulemaking 102 (2017), on December 6, 2016, the Supreme Court affirmed the conviction of Bassam Salman for insider trading, holding that under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, an insider may realize a personal benefit by gifting confidential information to a family member without actually realizing pecuniary gain. *Salman v. United States*, 137 S. Ct. 420 (2016). In the wake of *Salman*, the government may now try to demonstrate that Schulman gifted to investment advisor Tibor Klein inside information regarding Pfizer's plan to acquire King Pharmaceutical Inc., and that Klein subsequently traded on the information, resulting in $328,000 in profits. A grand jury indicted both Schulman and Klein for conspiracy to commit securities fraud in violation of 18 U.S.C. § 371 and securities fraud in violation of 15 U.S.C. §§ 78(b), (ff).

Schulman argued that permitting the government to proceed under the gift theory would constitute constructive amendment of the indictment, as the government did not present the gift theory to the grand jury. In addition, Schulman argued that at the time of his indictment, *Salman* had not yet overturned Second Circuit precedent requiring pecuniary gain to establish insider trading liability. The District Court denied Schulman's motion, finding the indictment sufficiently encompassed the possible legal theories that the government intends to advance at trial. Adopting the government's words, the Court found that "the core theory of the indictment remains the same irrespective of the benefit that the defendant received, *i.e.*, the defendant breached a duty not to disclose information in order to receive a benefit."

United States v. Tibor Klein, No. 16-cr-442(JMA), Docket No. 71 (E.D.N.Y. Feb. 2, 2017).

Supreme Court Revisits "*American Pipe*" to Decide Whether Tolling Applies to Section 13 of the 1933 Act

On January 13, 2017, the Supreme Court granted a petition for a writ of certiorari to determine whether statute tolling for putative class members applies to Section 13 of the 1933 Act's three year statute of repose. If tolling is applied, the Supreme Court will reinstate a previously time-barred class action lawsuit against the underwriters of more than $31 billion in Lehman Brothers' debt offerings.

As reported in 45 Q. Surv. SEC Rulemaking 98 (2017), the California Public Employees' Retirement System ("CalPERS") asserted claims under Section 11 of the 1933 Act, alleging that the Defendants were liable for false and misleading registration statements due to their failure to disclose risks related to Lehman's subprime mortgage investments. The District Court dismissed the suit as time-barred by the three-year statute of repose and the Second Circuit affirmed the dismissal.

In its certiorari petition, CalPERS argued that *American Pipe* tolling applies to statutes of repose. In *American Pipe & Construction Co. v. Utah*, the Supreme Court held that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action." 414 U.S. 538, 554 (1974). In granting certiorari, the Supreme Court limited its review to Question 1 of CalPERS' petition: "Does the filing of a putative class action serve, under the *American Pipe* Rule, to satisfy the three-year time limitation in Section 13 of the Securities Act with respect to the claims of putative class members?" The Court declined to decide whether a member of a timely filed putative class action may file an individual suit alleging the same claims before the class is certified, notwithstanding the expiration of the relevant time limitation.

The Supreme Court previously granted certiorari in *Public Employees' Retirement System of Mississippi v. IndyMac MBS, Inc.*, to determine whether *American Pipe* tolling applies to securities claims governed by Section 13's three-year limitations period. 134 S. Ct. 1515 (2014). The parties settled prior to oral argument, resulting in dismissal.

In re Lehman Brothers Sec. & ERISA Litig., No. 15-1879, 2016 WL 3648259 (2d Cir. July 8, 2016), *cert. granted, sub nom. Calif. Pub. Emp. Ret. Sys. v. ANZ Securities, Inc.,* 137 S. Ct. 811 (2017).

Supreme Court Petitioned to Hear SEC In-House Forum Issue; D.C. Circuit to Hear Same

On January 18, 2017, financier Lynn Tilton petitioned the Supreme Court for a writ of certiorari to determine whether SEC administrative law judges ("ALJs") are constitutional officers subject to the Appointment Clause. Controversy surrounding the constitutionality of SEC ALJs emerged in 2010, when the Dodd-Frank Act expanded the agency's jurisdiction to seek monetary penalties in-house against all individuals. The Federal Circuits remain divided on the controversy's jurisdictional and substantive issues.

As reported in 45 Q. Surv. SEC Rulemaking 103 (2017) and 44 Q. Surv. SEC Rulemaking 306 (2016), the SEC initiated administrative proceedings against Tilton in 2015, alleging she violated the Investment Advisers Act. Tilton challenged the administrative proceedings in Federal Court, alleging ALJ appointments violate the Appointments Clause of the Constitution. The District Court dismissed the suit for lack of subject matter jurisdiction and the Second Circuit affirmed.

Tilton's Supreme Court petition presents two questions: (1) whether Congress has authorized Federal district court jurisdiction over Appointments Clause challenges to SEC ALJs, and (2) whether SEC ALJs are inferior officers within the meaning of the Appointments Clause. The SEC's response was due April 21, 2017.

The District of Columbia Circuit scheduled en banc arguments for May 24, 2017, to reconsider an identical challenge to ALJ appointments filed by investment advisor Raymond Lucia. In August, the D.C. Circuit found that the SEC ALJ appointments are constitutional. In so holding, the D.C. Circuit was the first appeals court to consider the controversy's substantive issues. In December 2017, the Tenth Circuit concluded otherwise in *Bandimere v. S.E.C.*, finding ALJs are constitutional officers subject to the Appointment Clause and thus rendering the SEC's current appointment process unconstitutional.

Tilton v. S.E.C., 824 F.3d 276 (2d Cir. 2016), *petition for cert. filed* (Jan. 18, 2017) (No. 16-906).

Lucia v. S.E.C., 832 F.3d 277 (D.C. Cir. 2016), *vacated* (D.C. Cir. Feb. 16, 2017) (No. 15-1177).

Bandimere v. S.E.C., 844 F.3d 1168 (10th Cir. 2016).

Supreme Court Grants Certiorari to Decide Regulation S-K Item 303 Disclosure

On March 27, 2017, the Supreme Court granted a petition for a writ of certiorari in *Leidos, Inc. v. Indiana Public Retirement*

System, to determine whether Item 303 of SEC Regulation S-K creates a duty to disclose that is actionable under Section 10(b) of the 1934 Act.

Section 10(b) and Rule 10b-5 thereunder prohibit acts or omissions resulting in fraud or deceit in connection with the purchase or sale of securities. In addition, Item 303 requires a registrant to "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii). According to SEC guidance regarding Item 303, disclosure is necessary "where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial conditions or results of operations."

In *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015), the Second Circuit held that Item 303 imposes an "affirmative duty to disclose . . . [that] can serve as the basis for a securities fraud claim under Section 10(b)." In so holding, the Second Circuit split from the Ninth and Third Circuits. *See NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046 (9th Cir. 2014); *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000).

In *Leidos,* Plaintiffs sued Defendants under Section 10(b), claiming Defendant Saic Inc.'s ("Saic") (now known as Leidos, Inc.) March 2011 and June 2011 SEC filings failed to disclose potential liability arising from a fraudulent scheme, as required by Item 303. Specifically, Plaintiffs argued that Saic failed to disclose in its 10-K filings that it overbilled New York City hundreds of millions of dollars and that its overbilling practices subjected Saic to monetary and reputational risks, including loss of future government contracts. Saic argued that Plaintiffs failed to plead that Saic knew about the overbilling scheme at the time of the 10-K filing and that loss of certain government contracts was not material to its operations.

Applying *Stratte-McClure*, the Second Circuit held Plaintiffs adequately alleged that Saic failed to make required disclosures under Item 303. The Second Circuit found Plaintiffs' allegations supported a strong inference that Saic actually knew of the fraud prior to filing its Form 10-K and that, due to the fraud, New York City and New York State rejected pending contract awards. The Supreme Court will hear oral arguments during the October 2017 term.

Ind. Pub. Ret. Sys. v. Saic, Inc., 818 F.3d 85 (2d Cir. 2016), *cert. granted, sub nom. Leidos, Inc. v. Ind. Pub. Ret. Sys.,* 137 S. Ct. 1395 (2017).