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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (January 1, 2020—March 31, 2020)

*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 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, 2020 through March 31, 2020.

The SEC finalized six new rules for implementation, and proposed four new rules this quarter. The SEC's rulemaking this quarter seems to be similar in focus to the prior quarter, with several rule changes designed to streamline its regulatory framework and remove obstacles to capital formation, especially for smaller issuers. The key changes from the past quarter are summarized below.

The latter few weeks of this quarter has been a turbulent time as the SEC has enacted various temporary relief measures, provided staff guidance and made multiple public statements designed to help entities and individuals subject to SEC regulation cope with the COVID-19 pandemic. Note that the SEC has decided not to formally extend comment periods expiring in March 2020 for certain proposed actions in response to COVID-19, but has indicated that for certain pending items, the SEC will not take final action before May 1, 2020 to allow commenters additional time if needed. The staff will likely consider comments submitted after a close of the comment period but before rule finalization given the extenuating circumstances of the pandemic.

Proposed Rules

Private Offering Framework Overhaul

Following from their June 2019 Concept Release, the SEC has proposed this quarter a substantial set of changes to the exempt offering framework. As the current framework has evolved over

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*Mr. Silverman and Mr. Katz are members of the New York Bar and Partners at Olshan Frome Wolosky LLP. Associates Khasim Lockhart and Scott Kilian-Clark and legal intern Steven Moldavskiy assisted the authors.

time and responded to different legislative and rulemaking initiatives, it has become highly complex. Given that issuers bear the burden of establishing the availability of any exemption, compliance costs may be substantial, particularly for smaller issues. The proposal reviews in great detail the existing latticework of private offering regulation and seeks to harmonize and simplify rule regimes where the SEC believes possible "while preserving or enhancing important investor protections." The proposal is too extensive to address each recommended change individually in this article, but we highlight the following proposed changes of particular importance to issuers:

Integration of Offerings

The SEC has proposed new Rule 152 that would replace the integration provisions of Regulation D, Regulation A, Regulation Crowdfunding and Rules 147 and 147A. The new Rule 152 would replace the current five-factor integration test and attempt to resolve a common issue raised by commenters, namely, the circumstances under which an issuer may conduct concurrent exempt offerings.

Proposed Rule 152(a) would provide as a general principle that an issuer may conduct concurrent offerings complying under different rule regimes without integration concerns. For example, an issuer could undertake simultaneous offerings under Rules 506(b) and 506(c), provided that for an offering where general solicitation is prohibited, the issuer has a reasonable belief that the purchasers were not solicited through general solicitation (or had a substantive pre-existing relationship with the issuer). The analysis applies also to the integration of a registered offering with a general solicitation with an exempt offering that does not allow general solicitation. This will allow issuers seeking a public offering to raise money through a private placement before conducting a registered offering without integration issues.

In addition, proposed Rule 152(b) would establish four, clear, non-exclusive safe harbors that codify certain existing guidance on integration and provide for reduced waiting periods between offerings. Any offering made more than 30 days before the commencement of or after the termination of any other offering would not be integrated with such offering, provided that the solicitation rules discussed above are followed. The SEC proposes to remove Rule 155, which currently requires a six-month waiting period and the satisfaction of certain other conditions to avoid integration.

Test-the-Waters Communications

The SEC is proposing to extend the exemption for solicitations

of interest in an exempt offering. Initially created pursuant to the JOBS Act for solicitations of qualified institutional buyers (QIBs) and institutional accredited investors (IAIs), and later permitted for the general public in Regulation A offerings, these "test-the-waters" communications allow issuers to gauge interest in an exempt offering. The SEC believes that these communications are helpful because they allow investors to have input into the structuring of the offering. By complying with a new general exemption in Rule 241, issuers would be able to test the waters with generic solicitations of interest from the general public before deciding on which exemption to rely on in their private offering. The new rule borrows substantially from existing test-the-waters provisions in Regulation A, and would require certain notices and legends in such communications.

Offering and Investment Limits

The SEC hopes to make capital formation using Regulation A, Regulation Crowdfunding and Rule 504 more accessible by raising offering size limitations and loosening investment limitations. On a volume basis, these three regimes account for relatively little of the capital raised in exempt offerings, and the SEC would like to make them more viable options for issuers. Under the proposed rules, offering limits would be raised as follows: (i) Regulation Crowdfunding would have a $5 million offering limit instead of the current limit of $1.07 million, (ii) Rule 504 would have a $10 million offering limit instead of the current limit of $5 million, and (iii) Tier 2 Regulation A offerings would have a $75 million limit instead of the current limit of $50 million (along with a pro rata increase of the maximum offering for secondary sales). In addition, if the proposed applicable section of the rule is approved as drafted, investor suitability tests will be revised for both Regulation Crowdfunding and Tier 2 Regulation A investment to broaden the pool of potential investors, and dollar limits on Regulation Crowdfunding would be relaxed or removed.

Comments on the proposed rule should be received on or before June 1, 2020.

Amendments to Regulation S-K

The SEC has proposed a series of amendments to Regulation S-K under the 1933 Act that it believes would streamline disclosure and clarify requirements for publicly reporting companies. In particular, the SEC's proposed amendments focus on Items 301, 302 and 303, which prescribe certain reporting requirements for companies in their periodic reports on Form 10-K and 10-Q, and in their registration statements. This regulatory focus stems from legislative direction to study modernizing

disclosure practices, and draws from the SEC's April 2016 Concept Release covering Regulation S-K. The proposed changes both reorient the focus of Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") disclosure and eliminate disclosure items that the SEC now views as either unnecessary or duplicative of GAAP disclosure in the financial statements of registrants.

The SEC proposes to eliminate Items 301 and 302 of Regulation S-K. Item 301 requires certain registrants to provide financial data on their last five fiscal years. The SEC received numerous comments to its related Concept Release suggesting that the five-year disclosure requirement placed a burden on companies, with little benefit to investors. Some commentators argued that five-year historical information was of little use to investors, and that in most cases the information would be available via an EDGAR search of a company's past filings. The SEC proposes to eliminate the item wholesale, largely because of the electronic availability of equivalent information and the sufficiency of the disclosure required in the MD&A by Item 303 to break down trends in the registrant's continuing operations. The SEC proposes to eliminate Item 302 (requiring certain historical quarterly disclosure) for the much same reason, and states that a majority of comments it received on its April 2016 Concept Release supported the Item's removal.

The SEC would like registrants "to take a more principles-based approach" in their MD&A disclosure. In addition to removing unnecessarily prescriptive rules like those in Items 301 and 302, the SEC is proposing updates to Item 303 to encourage registrants to enhance their analysis in the MD&A section. In new Item 303(a), the SEC proposes to codify much of the substance of its instructions and existing guidance in order to "underscore materiality as the overarching principle of MD&A" and encourage registrants to offer disclosure particular to their business. Regarding interim quarterly reports, Item 303(b) would be revised to provide flexibility by allowing companies to compare their most recently completed quarter to either the corresponding quarter of the prior year (as is currently required) or to the immediately preceding quarter. The SEC does not want management to focus on fulfilling the technical requirements of a bright-line rules-based disclosure regime in the MD&A because they believe that approach discourages more useful and nuanced disclosure.

Among many updates to Item 303, the SEC proposes to update Item 303(a)(3)(ii) on known trends or uncertainties. The proposal would call for registrants to disclose known events that are "reasonably likely" to cause a material change in the relationship be-

tween costs and revenues, as opposed to the current rule that requires registrants disclose such trends only when certain that they will cause a material change. This change, though slight, is significant because it will require management to offer broader, more contingent disclosure on trends they are seeing in their business.

Comments on the proposed rule should be received on or before April 28, 2020.

Final Rules

Amendments to the Accelerated Filer and Large Accelerated Filer Definitions

The SEC has finalized amendments to the accelerated filer and large accelerated filer definitions with the intent of tailoring the types of issuers that are included in the categories of accelerated and large accelerated filers. The changes are also projected to promote capital formation, preserve capital and reduce unnecessary burdens for certain smaller issuers while maintaining investor protections. These definitional changes were required in order to accommodate the June 2018 expansion of the definition of a smaller reporting company ("SRC"), which created a great deal of overlap between two disclosure regimes at cross purposes. The changes have been finalized after the SEC's proposal from the second quarter of 2019 was met with many supportive comments. Many commentators agreed that the amendment would preserve capital for many corporations, while maintaining investor protection.

The most notable change stemming from this amendment is the addition of a new condition to the accelerated and large accelerated filer definitions in Rule 12b-2 promulgated under the 1934 Act. This change excludes from the accelerated and large accelerated filer definitions any issuer that is eligible to be an SRC and that had annual revenues of less than $100 million in the most recent fiscal year for which audited financial statements are available. This means that SRCs with less than $100 million in revenues will not be required to comply with accelerated or large accelerated filer requirements and, thereby, will not be subject to the internal control over financial reporting ("ICFR") auditor attestation requirement. The SEC projects that this change will reduce an estimated $210,000 per year in compliance costs for SRCs no longer required to obtain ICFR auditor attestation.

Another change includes an increase to the transition thresholds for accelerated and large accelerated filers becoming non-accelerated filers from $50 million to $60 million, and for exiting

large accelerated filer status from $500 million to $560 million. This amendment was made with the intent of reducing the frequency at which companies had to reclassify their filer status. Less frequent reclassifications are also expected to lead to reduced costs to the companies.

Finally, several small changes include adding a revenue test to the transition thresholds for exiting from both accelerated and large accelerated filer status, as well as adding a check box to the cover pages of Forms 10-K, 20-F and 40-F to indicate whether an ICFR auditor attestation is included in the filing. As a result of the amendments, certain low-revenue issuers will remain obligated, among other things, to establish and maintain ICFR and have management assess the effectiveness of ICFR, but they will not be required to have their management's assessment of the effectiveness of ICFR attested to, and reported on, by an independent auditor.

One notable adjustment to the proposal in the final rule is that the SEC decided to provide the same relief described above from application of the accelerated and large accelerated filer definitions to business development companies ("BDCs"). The final rule provides that BDCs will qualify for the same auditing exclusions as SRCs if they meet the requirements of the SRC revenue test using their annual investment income as the measure of annual revenue. However, it is important to note that BDCs will continue to be ineligible to be SRCs.

The final rule is effective as of April 27, 2020.

Rules Entering Use

Retail Investor Protections: Regulation Best Interest and Form CRS

In June 2019, the SEC adopted Rule 15*l*-1, also known as Regulation Best Interest ("Regulation BI"), under the 1934 Act. Regulation BI requires broker-dealers and associated persons to conform to a "best interest" standard of conduct when making recommendations to a retail customer of any securities transaction or investment strategy involving securities, including recommendations of types of accounts. The SEC coupled Regulation BI with a new Form CRS (an acronym standing for "Client Relationship Summary") and a related Amendment to Form ADV. Together, they complement Regulation BI by implementing additional disclosure requirements under the 1934 Act and the Investment Advisers Act of 1940, as amended (the "1940 Act") applicable to broker-dealers and investment advisors. Regulation BI became effective on September 10, 2019, with a nine-month transition period to enable firms to prepare compliant procedures and materials. Firms must comply with Regulation BI and begin

offering new Form CRS by **June 30, 2020**.[1]

Regulation BI's enhanced standard of care draws from the 1940 Act and the fiduciary standard applicable to investment advisers registered thereunder. However the SEC previously decided not to apply the 1940 Act to broker-dealers, opting instead to craft Regulation BI as a new standard that it believed would be less onerous than the fiduciary standard while providing more protection to retail investors than they are afforded under the current quantitative suitability analysis. The new regulation also fills the gap created by the decision of the Fifth Circuit to vacate the Department of Labor's proposed fiduciary rule, which would have curtailed the ability of broker-dealers to trade in assets of ERISA or IRA plans and receive transaction-based compensation for their services.

In order to comply with Regulation BI, broker-dealers must provide certain prescribed disclosure regarding applicable fees and conflicts, exercise reasonable care in making investment recommendations and maintain certain policies and procedures designed to address conflicts of interest. However, unlike registered investment advisors, broker-dealers will not have a duty to provide ongoing advice and monitoring of investments that they recommend. Retail customers are defined broadly to include natural persons (and their legal representatives) who seek to receive or receive services primarily for personal, family or household purposes, including high income or high net worth individuals. The SEC sought to balance the goals of providing retail investors with increased disclosure and protection from conflicts of interest and investment professionals' desire to provide their customers access to a broad range of investment products.

Commencing June 30, 2020, upon beginning a relationship with a new client, broker-dealers and investments advisors will be required to issue their retail customers a new disclosure document designed to state succinctly the fees, conflicts, standards of conduct and disciplinary history of the applicable advisor and his or her firm. Form CRS is designed as a plain language question and answer, to run no longer than two pages (four for dual registrants) and comes with prescribed SEC questions covering the aforementioned topics. The form will also include SEC-prepared "conversation starters" throughout, designed to guide customers to ask informed follow-up questions regarding the relationship. The SEC intends to review a sample of the relationship summaries devised by firms (first required to be filed by June 30, 2020) and may provide additional guidance as to the contents of these disclosures going forward.

United States Court of Appeals for the Tenth Circuit Affirms Lower Court's Dismissal of Plaintiffs' Allegations Grounded upon Fraud by Hindsight

On February 25, 2020, the United States Court of Appeals for the Tenth Circuit affirmed the United States District Court for the District of Colorado's dismissal of an Amended Complaint brought by Lawrence Henry Smallen and the Laura Anne Smallen Revocable Living Trust (collectively, "Plaintiffs"), against The Western Union Company ("Western Union") and several of its current and former officers (collectively, ("Defendants"). Plaintiffs alleged that Defendants violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder and Section 20(a) of the Securities Exchange Act by making misrepresentations and omissions concerning its compliance with anti-money laundering and anti-fraud laws.

On February 22, 2017, Plaintiffs filed a Putative Class Action Complaint on behalf of all investors who purchased or acquired stock between February 24, 2012, and May 2, 2017 (the "Class Period"). On January 19, 2017, Western Union reached a settlement with several federal regulators to resolve investigations related to its anti-money laundering and anti-fraud programs. As part of the settlement, Western Union admitted to failing to implement an effective anti-money laundering compliance program from December 2004 through December 2012. Plaintiffs alleged that statements made by Defendants during the Class Period in public and in SEC filings pertaining to Western Union's compliance efforts were misleading. First, Plaintiffs alleged that various "red flags," which included (i) 550,928 consumer complaints between January 1, 2004, and August 29, 2015, (ii) fraudulent transfers involving Western Union's agents, (iii) and the arrests of several third-party agents, must have alerted the Defendants of Western Union's compliance problems. Second, Plaintiffs alleged that discussions during Western Union's board and committee meetings whereby board members discussed regulators' increased attention to Western Union's agents and the need improvement in compliance programs evidenced their knowledge of deficiencies with the compliance programs. Third, Plaintiffs refer to government investigations into Western Union's legal compliance, interactions with regulators and the company's disclosures in SEC filings regarding these matters. Fourth, Plaintiffs point to Western Union's admissions in documents and statements relating to its January 19, 2017 settlement as evidence of its knowledge of its non-compliance. Western Union's stock price experienced a significant drop after Defendants announced its settlements with regulators in January 2017.

The United States Court of Appeals for the Tenth Circuit Court

found that Plaintiffs failed to show particularized allegations showing that Defendants, before the announcement of the January 19, 2017 settlement, knew of or recklessly disregarded the falsity of the challenged statements when those statements were made. The Court stated "Plaintiff[s] may not rely on a subsequent event triggering a decrease in stock price 'to say that the later sobering revelations make the earlier, cheerier statement a falsehood.' "

Smallen v. W. Union Co., 2020 WL 893826 (10th Cir. Feb. 25, 2020).

C.D. Cal. Dismisses Securities Class Action Again

On February 25, 2020, the District Court for the Central District of California, Judge Cormac J. Carney, dismissed a putative securities class action against Emulex Corporation ("Emulex"), a telecommunications company. Plaintiff brought a cause of action against the company for making material misstatements and omissions in violation of Section 14(e) of the Securities Exchange Act of 1934.

In 2015, Emulex merged with Avago Technologies Wireless (U.S.A.) Manufacturing, Inc. ("Avago"). Avago initiated a tender offer for $8.00 per share, a 26.4% premium, of outstanding Emulex stock. Goldman Sachs evaluated the offer, and determined the price was fair to the Emulex shareholders based on multiple different analyses. Emulex issued a Recommendation Statement to shareholders, which included a five-page summary of Goldman Sachs opinion. Within this summary, Emulex referenced four out of the five analyses Goldman Sachs performed. The omitted analysis was the "Premium Analysis" in which Goldman Sachs selected similar transactions to the proposed merger and compared the premiums. Goldman Sachs found that the 26.4% premium was below average, but within the range of comparable transactions. Emulex shareholders used the omitted Premium Analysis as the bases for their Section 14(e) claim.

The case was first dismissed in January 2016, with the Court holding that the plaintiff failed to properly allege scienter. Plaintiff appealed, and the Ninth Circuit reversed in part, finding that Section 14(e) requires a showing of only negligence, not scienter. Emulex appealed to the Supreme Court, challenging the Ninth Circuit's departure from five other circuits' scienter requirement. Although the petition for writ of certiorari was granted, it was dismissed as improvidently granted without addressing the issues raised.

Emulex's motion to dismiss the Section 14(e) claim returned to the District Court to be evaluated under the negligence standard. The Court analyzed whether the fact the Recommendation State-

ment did not include the Premium Analysis, a single page chart, was a material misleading omission. The Court agreed with Emulex's argument that "Plaintiff has not identified statements that were rendered misleading as to a material fact by the omission of the Premium Analysis, as required by the PSLRA." Opinion at 15–16. In reaching this conclusion, the Court highlighted several important facts.

First, plaintiff mischaracterized the Recommendation Statement. The purpose of the Recommendation Statement was to advise the shareholders as to whether the Avago tender offer was fair, and not whether the tender offer was above or below average. Second, the Recommendation Statement used metrics that were "entirely consistent" with the Premium Analysis to show that the premium was below average, but within a reasonable range. Third, the Recommendation Statement contained a summary of the Goldman Sachs fairness opinion, and a summary "cannot be expected to include every relevant or meaningful bit of analysis performed by a financial advisor." Finally, plaintiff failed to sufficiently explain why the summary of the fairness opinion was misleading, as nothing in the summary gave the false impression that the premium was above average.

Gary Varjabedian v. Emulex Corp. et al., 8:15-cv-00554 (C.D. Cal. Feb. 25, 2020).

NOTES:

[1]The SEC's Office of Compliance Inspections and Examinations confirmed in its the Risk Alert published on April 7, 2020 that the SEC has not extended the compliance date in response to COVID-19.