

Securities Regulation Law Journal

Volume 45 Number 3

Fall 2017

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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (April 1, 2017-June 30, 2017)

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 April 1, 2017 through June 30, 2017.

For over 10 years, Victor Rosenzweig was responsible for writing this quarterly Survey. Victor passed the torch shortly after completing the prior quarter's Survey. For over 20 years, Victor has been a mentor, colleague and friend, and I have had the good fortune to have worked with him on a number of transactions and other matters during that time. Both Brian and I are honored to take the reins from him and to continue the good work that he has done here. The colleagues assisting me in this undertaking are aware that we have big shoes to fill. Thank you Victor for all your work.

Preparing this first column proved to be a challenge. The first full quarter of a new presidential administration saw the confirmation of a new SEC chair and new appointments. Not surprisingly, the SEC was not particularly active on the rulemaking front given this transition. Consequently, we broadened the scope of this quarterly Survey to include a summary of certain key personnel changes at or near the top of the SEC's leadership as they will shape policy and rulemaking for the foreseeable future.

New SEC Chairman and Other Key Personnel Changes

On May 2, 2017, the U.S. Senate confirmed President Donald Trump's nomination of Jay Clayton, a political independent, as chair of the SEC in a 61-37 vote. Clayton was a longtime partner

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at Sullivan & Cromwell, where he represented many of Wall Street's biggest banks and financial institutions in transactional and regulatory matters. He has repeatedly declared that he wants to make it easier for companies to raise money in public markets and announced at his confirmation hearing that he wants the SEC to review whether rules linked to The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") are achieving their objectives. Clayton's confirmation makes him the third commissioner of the five-person Commission, leaving two vacancies remaining. The rumors that President Trump may tap Hester Pierce, a former SEC counsel and Senate aide, to fill the open Republican seat were confirmed when he formally submitted her nomination to Congress on July 19, 2017.

While the SEC has yet to propose any major rules since Clayton took the helm in early May, he has been steadily assembling a team of senior aides to assist in carrying out his agenda. In this regard, the SEC announced on May 15, 2017, that Robert Stebbins will serve as the agency's general counsel after practicing law as a partner at Willkie Farr & Gallagher and Sean Memon, who was an associate at Sullivan & Cromwell, will join the Commission as its deputy chief of staff. The SEC also announced the same day that Jaime Klima will act as the chief counsel to Chair Clayton, where she will be the senior legal and policy advisor and will coordinate the agency's rulemaking agenda. Prior to this appointment, Ms. Klima served as the SEC's co-chief of staff under then-Acting Chairman Michael Piwowar. On June 8, 2017, the SEC announced that Steven Peikin, who managed Sullivan & Cromwell's criminal defense and investigations group and previously served as a federal prosecutor, will co-head the Commission's Division of Enforcement with Stephanie Avakian, who had been serving as the Division's Acting Director. In late June, Clayton reportedly appointed Bryan Wood, a former Republican staff member on the House Financial Services Committee, to serve as a liaison between the SEC and Congress in an effort to manage the SEC's relationship with the lawmakers that approve its budget. The SEC announced on July 24, 2017, that Mr. Wood was named Director of the SEC's Office of Legislative and Intergovernmental Affairs.

SEC Expands Eligibility to All Issuers for Non-Public Review of Draft Registration Statements

Consistent with Chair Clayton's goal of increasing capital formation, on June 29, 2017, the SEC announced that its Division of Corporate Finance will permit all issuers to submit draft registration statements relating to initial public offerings, as well as most offerings made in an issuer's first year of public report-

ing, for review on a non-public basis, beginning on July 10, 2017. This will extend to all companies a popular benefit that has been available to emerging growth companies under the Jumpstart Our Business Startups Act (the “JOBS Act”) since 2012. Emerging growth companies are defined under the JOBS Act as companies with annual gross revenues of less than \$1.07 billion (initially \$1 billion, but adjusted for inflation in April 2017) during its most recent fiscal year. The expanded non-public review will be available to all issuers for drafts of (i) all initial registration statements (and related revisions) pursuant to the 1933 Act; (ii) all initial registration statements (and related revisions) pursuant to section 12(b) of the 1934 Act; and (iii) all registration statements pursuant to the 1933 Act within one year following the effective date of an initial registration statement referred to in (i) or (ii) above.

As with emerging growth companies, any issuer utilizing this procedure when conducting an initial registration under the 1933 Act or section 12(b) of the 1934 Act must publicly file not only its final registration statement, but also the initial non-public draft registration statement and all draft amendments thereto, at least 15 days prior to conducting any road show or, if there is no road show, at least 15 days prior to the registration statement’s effective date. Additionally, any issuer requesting non-public review in connection with an offering within one year following its initial registration must publicly file its final registration statement and non-public draft submission at least 48 hours prior to any requested effective time and date. The SEC stated that non-public review for these follow-on offerings will be limited to the initial submission, however, and that any issuer’s comments on such a draft registration statement must be through a public filing.

Not all benefits available to emerging growth companies through the JOBS Act are extended to other issuers. One important distinction is that issuers other than emerging growth companies are not able to omit from a publicly filed registration statement financial information that they reasonably believe will not be required to be included in the registration statement at the time of the contemplated offering. These issuers are, however, able to omit from a draft registration statement financial information they reasonably believe will not be required at the time the registration statement is publicly filed. Additionally, such issuers may not use test-the-waters communications with qualified institutional buyers and institutional accredited investors.

In a press release issued on the same day as the announcement, the SEC stated that permitting all companies to submit registrations statements for non-public review is consistent with its efforts to facilitate capital formation and protect investors, as

it will provide companies with more flexibility to plan their offerings and will reduce the potential for lengthy exposure to market fluctuations that can be harmful to the offering process and existing public shareholders.

SEC Proposes Amendments to Advisers Act Rules to Reflect Changes Made by FAST Act

On May 3, 2017, the SEC proposed to amend rules 203(l)-1 and 203(m)-1 under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), to reflect changes made by title LXXIV, sections 74001 and 74002 of the Fixing America’s Surface Transportation Act of 2015 (the “FAST Act”). The FAST Act amended sections 203(l) and 203(m) of the Advisers Act regarding the registration of investment advisers to small business investment companies (“SBICs”). Title LXXIV, section 74001 of the FAST Act amended the exemption from investment adviser registration for any adviser solely to one or more “venture capital funds” in section 203(l) of the Advisers Act by deeming SBICs to be “venture capital funds” for purposes of the exemption. Title LXXIV, section 74002 of the FAST Act amended the exemption from investment adviser registration for any adviser solely to private funds with less than \$150 million in assets under management in section 203(m) of the Advisers Act by excluding the assets of SBICs for purposes of calculating private fund assets towards the registration threshold of \$150 million. Accordingly, the SEC proposed to amend the definition of “venture capital funds” in Advisers Act rule 203(l)-1 to include SBICs and to amend the definition of “assets under management” in Advisers Act rule 203(m)-1 to exclude the assets of SBICs, to make these rules consistent with the FAST Act’s amendments to the Advisers Act. **(See Release No. IA-4697)**

Comments on the proposed rule amendments required submission on or before June 8, 2017.

SEC Approves FINRA Rule Change Giving Parties More Time to Choose Arbitrators

On June 19, 2017, the SEC approved a rule change by the Financial Industry Regulatory Authority (“FINRA”) allowing parties selecting a FINRA arbitration panel to have more time to choose their arbitrators. Under the current rule, parties to a FINRA arbitration proceeding receive a list of qualified arbitrators from FINRA’s Office of Dispute Resolution within 30 days after the last response to allegations is due, even if the parties had agreed to extend the due date. Under the new rule, the arbitrator list must be sent to the parties within 30 days after the original due date for the last answer, regardless of any extension. FINRA

stated that this rule change could shorten the duration of arbitration proceedings in those circumstances where the parties extend the answer due date by allowing the parties to evaluate the arbitrator list at the same time that they prepare their responses. The SEC commented in its order approving this rule change that it believes the new rule will help protect investors and the public by streamlining the arbitration process. The new rule becomes effective on July 24, 30 days after publication in the Federal Register. (See Release No. 34-80973)

SEC to Seek Comment on Issues Related to DOL's Fiduciary Rule

On June 1, 2017, SEC Chair Jay Clayton declared in his first policy announcement since assuming the role that the SEC would seek public comment on a range of issues related to a regulation promulgated by the U.S. Department of Labor (the "DOL") designed to reduce conflicted investment advice given to retirement savers. This regulation, commonly referred to as the "Fiduciary Rule," requires that retirement advisers place their customers' interests ahead of their own. The applicability date for most provisions of the Fiduciary Rule was originally scheduled for April 10, 2017, but was delayed for 60 days by the DOL in response to a memorandum executed by President Donald Trump directing the agency to further examine the regulation to ensure it does not adversely affect the ability of Americans to gain access to retirement information and financial advice. The provisions of the Fiduciary Rule originally set to take effect on April 10 became applicable on June 9, and the remaining provisions are scheduled to take effect on January 1, 2018.

The SEC, which regulates providers of financial advice, has not yet initiated any rulemaking in connection with the Fiduciary Rule, though it is authorized to do so by the Dodd-Frank Act. That legislation permits, but does not require, the SEC to impose a "best interest" standard on all brokers, dealers and investment advisers that provide personalized investment advice to retail customers. In the June 1 announcement, Chair Clayton welcomed the DOL's request to collaborate in this area and noted that he is eager to engage with the SEC staff, retail investors and other market participants to assess possible future actions for the SEC. The announcement specified several topics on which the SEC hopes to receive public input but also invited submission of any other data or information that may inform the SEC's analysis in this regard.

Appellate and Other Decisions of Note

Ninth Circuit Holds *Omnicare* Applies to Section 10(b) and Rule 10b-5 Claims

On May 5, 2017, the Ninth Circuit held that the standard for analyzing whether a statement of opinion in a registration statement is materially misleading for purposes of claims under Section 11 of the 1933 Act also applies to claims under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder. In so holding, the Court affirmed the dismissal of a class action alleging Defendants made false and misleading statements regarding the goodwill value of a subsidiary.

In April 2011, Defendant Align Technology, Inc. (“Align”) purchased Cadent Holdings, Inc. for \$187.7 million and allocated \$76.9 million of the purchase price as goodwill. In October 2012, Align announced that it was conducting an interim goodwill impairment test due to poor third quarter performance that resulted in a 20% stock price decline. Between November 2012 and April 2013, Align announced a series of goodwill impairment charges, ultimately announcing full impairment of the remaining goodwill. Plaintiff investors, who purchased Align stock between January 31, 2012 and October 17, 2012, commenced suit in the District Court for the Central District of California, alleging Defendants made materially false and misleading statements regarding Cadent’s goodwill valuation in press releases and Forms 8-K, 10-K, and 10Q.

The District Court dismissed the second amended complaint, finding Plaintiff failed to adequately allege falsity or scienter. The District Court applied *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund*, in which the Supreme Court established three standards for pleading falsity of opinion statements in regards to Section 11 claims. Plaintiff appealed and the Ninth Circuit affirmed, concluding *Omnicare* applies equally to § 10(b) claims.¹ Under *Omnicare*, when proceeding on a theory of material misrepresentation, a plaintiff must allege that “the speaker did not hold the belief she professed” and that her belief was objectively untrue. 135 S. Ct. 1318, 1327. Proceeding on the theory that a statement of fact contained a materially misleading opinion statement, a plaintiff must allege “the supporting fact [the speaker] supplied [was] untrue.” *Id.* Proceeding on a theory of omission, a plaintiff must allege “facts going to the basis for the issuer’s opinion . . . whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context.” *Id.* at 1332. Applying *Omnicare*, the Ninth Circuit affirmed, holding the complaint contained no allegations that Defendants believed Cadent’s

goodwill was impaired at the time of acquisition or when Align issued the financial statements at issue. The Court further held that Plaintiff did not establish a strong inference of scienter, because the complaint did not establish that Defendants knew or recklessly disregarded that the goodwill valuation was inflated.

City of Dearborn Heights Act 345 Police & First Ret. Sys. v. Align Tech., Inc., 856 F.3d 605 (9th Cir. 2017).

Tenth Circuit and Supreme Court Reject Petitions in Administrative Judge Challenges, D.C. Circuit Splits Over Constitutionality

On May 3, 2017, the Tenth Circuit rejected the SEC's petition for a rehearing or a rehearing en banc on whether SEC administrative law judges (ALJs) are constitutional officers subject to the Appointments Clause. On May 30, 2017, the Supreme Court denied financier Lynn Tilton's petition for a writ of certiorari to determine the same issue. On June 26, 2017, the D.C. Circuit split over whether the SEC ALJ appointment process is consistent with the Constitution.

With regard to the Tenth Circuit, on December 27, 2016, a divided Circuit panel found SEC ALJs constitutional officers subject to the Appointments Clause. The SEC petitioned the Circuit to review the panel's decision. On May 30, 2017, the majority of the original panel denied the rehearing request. Similarly, a majority of Tenth Circuit judges in active regular service denied en banc consideration. Judges Carlos F. Lucero and Nancy L. Moritz dissented from the denial of rehearing en banc. The dissenting judges found en banc review "not only appropriate, but necessary," because "the majority opinion fails to accord proper deference to the constitutional structure of checks and balances and agency separation of functions that flow from that fundamental construct." *Bandimere v. S.E.C.*, 844 F.3d 1128, 1129 (10th Cir. 2017). The dissenting judges further argued that the majority opinion "presents a threat of disruption throughout our government" and "fails to respect the carefully crafted procedural protections incorporated in the Administrative Procedure Act." *Id.*

With regard to the Supreme Court's denial of certiorari, Tilton first challenged the propriety of ALJ appointments in 2015 after the SEC initiated an administrative proceeding alleging she overcharged investors in loan securities. The District Court for the Southern District of New York dismissed Tilton's suit for lack of subject matter jurisdiction and the Second Circuit affirmed. As reported in 45 Q. SURV. SEC RULEMAKING 151, Tilton petitioned the Supreme Court for review on January 18, 2017. Tilton's petition presented 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. On May 30, 2017, the Supreme Court denied Tilton's petition.

With regard to the D.C. Circuit decision, the Court first held that SEC ALJs are not officers subject to the Appointments Clause in August 2016. The D.C. Circuit subsequently vacated its decision and granted Petitioner Raymond Lucia's request for rehearing. The D.C. Circuit heard oral argument on May 24, 2017, but was unable to reach a majority opinion. As the Tenth and D.C. Circuits remain divided, the constitutionality of SEC ALJ appointments remains ripe for Supreme Court review.

Tilton v. S.E.C., 137 S. Ct. 2187 (2017).

Bandimere v. S.E.C., 844 F.3d 1128 (10th Cir. 2017).

Lucia v. S.E.C., No. 15-1345, 2017 WL 2727019 (D.C. Cir. June 26, 2017).

Third Circuit Affirms Insider Trading Liability, Finds Non-Public Retail Purchase Data Material

On April 10, 2017, the Third Circuit affirmed a \$13.5 million verdict against former Capital One analyst Nan Huang for insider trading, finding non-public data regarding retail purchases made with Capital One credit cards constituted material information.

The SEC alleged that Huang downloaded confidential information regarding retail purchases made with Capital One credit cards, analyzed monthly transactions for various companies, and compared the transaction data with publicly available historical data regarding each company's total reported revenue. From this mix of public and non-public data, Huang accurately projected quarterly revenues for these companies approximately one month before revenue announcements. Huang made more than 2000 trades in the securities of these retail companies and realized a 12,929% three-year return on his investment.

In the District Court for the Eastern District of Pennsylvania, a jury convicted Huang of insider trading and the Court subsequently denied Huang's motion for judgment as a matter of law. On appeal, Huang argued that the District Court erred in denying his motion for judgment as a matter of law, claiming the SEC presented insufficient evidence to demonstrate the Capital One data at issue was material. Insider trading in violation of Section 10(b) of the 1934 Act and Rule 10b-5 thereunder requires a showing of materiality. Information is deemed material if there a substantial likelihood that it would have been viewed by a reasonable investor as having significantly altered the total mix of information available. The Third Circuit found that this retail

purchase data, which provided early and nonpublic insight into whether stock value was likely to increase or decrease after quarterly revenue announcements, would have significantly altered the total mix of information available to a reasonable investor and thus was material.

S.E.C. v. Huang, No. 16-2390, 2017 WL 1315664 (3d Cir. Apr. 10, 2017).

First Circuit Dismisses Pharmaceutical Investor Fraud Suit Finding No Scienter

On April 7, 2017, the First Circuit affirmed the dismissal of an investor suit alleging Defendant Zafgen Inc. (“Zafgen”) artificially inflated its common stock price via materially misleading statements and omissions concerning its anti-obesity drug in violation of Sections 10(b) and 20(a) of the 1934 Act. The First Circuit found the amended complaint failed to allege a compelling inference of scienter, as required under the Private Securities Litigation Reform Act.

During Phase II clinical trials of Zafgen’s anti-obesity drug, two patients experienced serious adverse thrombotic events and two patients experienced superficial adverse thrombotic events. Defendants disclosed the serious thrombotic events, but failed to disclose the superficial events. Zafgen’s stock prices later plunged after a clinical trial patient died and the Food and Drug Administration instituted a partial clinical trial hold. Plaintiffs commenced suit in the District Court for the District of Massachusetts. The District Court granted Defendants’ motion to dismiss, finding the complaint failed to allege facts giving rise to a compelling inference of scienter.

On appeal, Plaintiffs argued that Defendants’ disclosures regarding clinical trial results were incomplete and thus materially misleading. Plaintiffs further alleged that Defendants knew, or were reckless in not knowing, about the significant risk of adverse thrombotic events in future clinical trials. The First Circuit affirmed the District Court’s dismissal, finding that while Defendants may have “had an awareness of some connection” between the drug and thrombotic events, Plaintiffs failed to establish that Defendants “deliberately or recklessly risked misleading investors by not disclosing the two superficial adverse thrombotic events.” *Brennan v. Zafgen, Inc.*, 853 F.3d 606, 614–15 (1st Cir. 2017). The Court noted that its “conclusion is especially warranted,” given the complaint fails to allege “‘warnings by subordinates or expressions of concern by executives’ regarding the propriety of allegedly deceptive disclosures.” *Id.* at 615. The Court further found Plaintiffs’ insider trading allegations weak, given that most Zafgen insiders retained the majority of their

holdings. Addressing other considerations, the Court found it unlikely that a reasonable investor would have viewed the two superficial adverse thrombotic events as significantly altering the mix of information available to them. In addition, the Court found that Defendants' disclosures during the class period further undermine a showing of scienter, as Defendants disclosed to investors the more serious thrombotic events and informed investors that they would not disclose all adverse events.

Brennan v. Zafgen, Inc., 853 F.3d 606 (1st Cir. 2017).

Supreme Court Finds “*American Pipe*” Tolling Does Not Apply to 1933 Act’s Statute of Repose

On June 26, 2017, the Supreme Court held that that Section 13 of the 1933 Act provides a three-year statute of repose that is not subject to equitable tolling.

As reported in 45 Q. SURV. SEC RULEMAKING 98 (2017) and 45 Q. SURV. SEC RULEMAKING 150 (2017), Plaintiff California Public Employees Retirement System alleged that underwriters of more than \$31 billion in Lehman Brothers' debt offerings were liable for false and misleading registration statements due to their failure to disclose risks related to subprime mortgage investments. In 2008, a class action was filed against Defendants in the Southern District of New York and Plaintiff was a member of the putative class. In February 2011, more than three years after the relevant securities offerings, Plaintiff filed this action in the Northern District of California—alleging identical claims to the 2008 class action. The parties to the class action reached a proposed settlement, but Plaintiff opted out of the class in order to pursue recovery in its separate suit.

Defendants moved to dismiss this action as untimely and Plaintiff argued that Section 13's three-year statute of repose was tolled during the pendency of the 2008 class action. The District Court disagreed and the Second Circuit affirmed. On January 13, 2017, the Supreme Court granted Plaintiff's petition for a writ of certiorari. Plaintiff argued that Section 13's statute of repose is subject to tolling based on the Supreme Court's rationale and holding in *American Pipe & Construction Co. v. Utah*. In *American Pipe*, the Supreme Court held that the “commencement of a class action suspends the applicable statute of limitations as to all asserted member 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 the case at bar, the Supreme Court classified *American Pipe* tolling as an exercise of judicial equity and declined to extend such tolling to statutes of repose. In so holding, the Supreme Court noted that statutes of repose create an absolute bar on a defendant's temporal liability and are only

subject to tolling pursuant to an indication that the legislature did not intend the statute to provide complete repose. Though courts have used equitable powers to override statutes of limitations, statutes of repose “displace[] the traditional power of courts to modify statutory time limits in the name of equity.”

Calif. Pub. Emps. Ret. Sys. v. ANZ Sec., Inc., 137 S. Ct. 2042 (2017).

NOTES:

¹The Second Circuit reached an identical conclusion in *Tongue v. Sanofi*, 816 F.3d 199, 209–10 (2d Cir. 2016).