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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (October 1, 2018–December 31, 2018)

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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 October 1, 2018 through December 31, 2018.

The SEC had a busy final quarter for the 2018 year. The SEC finalized 11 new rules for implementation, almost double what it finalized in the third quarter of 2018, and more than any other quarter in 2018. Further, the SEC proposed five new rules this quarter. While some of the rules relate to technical matters, the focus of the SEC's rulemaking this quarter seems to be on disclosure and the ability for investors to make better-informed long-term decisions. The key changes are summarized below. Further, in October 2018, the SEC released its semi-annual regulatory docket outlining its current rulemaking initiatives. The list contains 36 items targeted for completion in the next 12 months, up from 21 items on last spring's regulatory docket.

Final Rules

Amendments to Regulation A

The SEC has finalized amendments to 17 CFR 230.251 ("Rule 251") and 17 CFR 230.257 ("Rule 257") under the 1933 Act, which are part of Regulation A. Once implemented, the amendments will broaden eligibility for exemption from full SEC securities registration and allow entities to rely on the Regulation A exemption for certain SEC reporting requirements. The amendment seeks to provide reporting companies with additional flexibility when raising capital.

As currently stated, Regulation A provides an exemption from registration under the 1933 Act for offerings of securities up to

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$50 million. The new amendments revise Rule 251(b), as mandated by the Economic Growth, Regulatory Relief, and Consumer Protection Act. The revisions to Rule 251(b) permit entities subject to Sections 13 or 15(d) of 1934 Act to use Regulation A and revise Rule 257 to provide those entities that meet the reporting requirements set forth in the Exchange Act will be deemed to have met the reporting requirements of Regulation A. The amendments make conforming changes to Form 1-A. The amendments become effective upon publication in the Federal Register.

Disclosure of Hedging by Employees, Officers and Directors

The SEC is implementing a new disclosure rule for proxy statements and information statements relating to an election of directors. The new rule requires a company to disclose and describe any practices or policies adopted by the company pertaining to the ability of its directors, employees or officers to purchase financial instruments or engage in transactions that hedge or offset any decrease in the market value of equity securities granted as compensation. Companies must also disclose those practices or policies in which employees, directors or officers can hedge or offset any decrease in the market value of equity securities held directly or indirectly by the employee, director or officer. Disclosures must be made in proxy statements or information statements relating to an election of directors and requires a company to describe the practice or policies and list the categories of individuals affected by the practice or policy. Further, if a company does not have any such practice or policy, a company is required to either disclose that fact or, alternatively, disclose that hedging is generally permitted. The aim of this new rule is to inform stockholders as to whether employees, officers or directors are allowed to engage in certain transactions that may lessen the risks associated with their long-term ownership of their company's equity securities. The SEC has stated that this new rule does not require a company to revise its practices, policies or related disclosure where the company already discloses its hedging practices and policies.

The rule is being adopted to implement a certain provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Smaller reporting companies and emerging growth companies are required to comply with these new disclosures during fiscal years beginning on or after July 1, 2020. All other companies must comply with the disclosure requirements during fiscal years beginning on or after July 1, 2019.

Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or be Involved in Effecting Security-Based Swaps

The SEC is adopting Rule of Practice 194, pursuant to Section 15F(b)(6) of the 1934 Act. The new rule provides a broader base of security-based swap transactions by providing a process for a registered security-based swap dealer or major security-based swap participant (together, "SBS Entity") to make an application to the SEC to permit an associated person that is a natural person who is subject to a statutory disqualification ("Natural Person") to effect or be involved in effecting security-based swaps on behalf of the SBS Entity. The rule additionally provides that an SBS Entity does not need to make an application pursuant to Rule of Practice 194 to permit a Natural Person to effect or be involved in effecting security-based swaps on its behalf where the SEC, the Commodity Futures Trading Commission, a registered futures association or a self-regulatory organization has granted a prior application or relief from the statutory disqualification regarding the Natural Person at issue. Lastly, Rule of Practice 194 creates an exclusion for an SBS Entity for associated persons that are not Natural Persons. Rule of Practice 194 goes into effect 60 days after publication in the Federal Register.

Covered Investment Fund Research Reports

Effective January 14, 2019, the SEC is adopting a new rule under the 1933 Act to establish a safe harbor for unaffiliated brokers or dealers who participate in securities offerings of covered investment funds to publish or distribute covered investment fund research reports. The new rule sets forth several conditions, which, if satisfied, allow for the publication or distribution of a covered investment fund research report to be deemed not to be an offer for sale or offer to sell the covered investment fund's securities.

Modernization of Property Disclosure for Mining Registrants

Effective February 25, 2019, the SEC will implement changes to Item 102 of Regulation S-K in an attempt to modernize the disclosure requirements for mining registrants. These changes are expected to enable investors to make more informed investment decisions by providing a more comprehensive understanding of a registrant's mining properties. In addition, this amendment seeks to align SEC disclosure requirements with current industry and international regulatory practices. The new amendment rescinds Industry Guide 7 and relocates the disclosure requirements to a new location under Regulation S-K.

The new rule requires an SEC registrant with material mining operations to disclose certain information in its filings concerning the mineral resources and mineral reserves of the company. Prior to the implementation of this new rule, the SEC only required registrants with material mining operations to disclose mineral reserves. By requiring the additional disclosure of mineral resources, the SEC aims to provides investors with more comprehensive information regarding a registrant's operations.

The amendments must be complied with beginning with the first fiscal year on or after January 1, 2021 and applies only to registrants engaged in mining operations.

Proposed Rules

Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

The SEC has proposed an amendment to the regulations implementing the Bank Holding Company's Act's restrictions on proprietary trading and relationships with hedge funds and private equity funds. The proposed rule seeks to implement these amendments in a manner consistent with those statutory amendments made pursuant to the Economic Growth, Regulatory Relief, and Consumer Protection Act. The statutory amendments exempt certain firms that have total consolidated assets equal to $10 billion or less from restrictions on proprietary trading. These statutory amendments also exclude from these restrictions firms that have total trading assets and liabilities equal to five percent or less of total consolidated assets and amend the restrictions applicable to the naming of a hedge fund or private equity fund to permit an investment adviser who is also a banking entity to share a name with the fund.

On the Horizon

Earnings Releases and Quarterly Reports

On December 18, 2018, the SEC requested public input on earnings releases and quarterly reports made by reporting companies. Specifically, the SEC requested comment on the nature, content and timing of earnings releases and quarterly reports. The SEC is looking to better the process by soliciting input on how it can reduce burdens, particularly administrative hardships, caused by quarterly reporting. Despite this request, the SEC aims to maintain, and even heighten, disclosure effectiveness and investor protections. The SEC hopes to improve its rules so that the rules reflect the need for companies and investors to plan long term.

Appellate and Other Decisions of Note

Northern District of Georgia Denies Defendant's Motion to Dismiss Indictment, Finding Internet Searches Sufficient to Demonstrate "Use" of Material Nonpublic Information

On December 4, 2018, the United States District Court for the Northern District of Georgia denied Defendant's motion to dismiss his indictment, holding that the Government adequately demonstrated Defendant used inside information in violation of Section 10(b) and Rule 10b-5 thereunder, based on the subject matter and suspicious timing of internet searches Defendant conducted.

Defendant formerly served as the Chief Information Officer (CIO) for Equifax Inc. While Defendant served as Equifax's CIO, Equifax's databases were hacked from May 2017 until July 2017. Equifax discovered the data breach on July 29, 2017, but the Government alleged that Defendant was not aware of the system-wide breach until August 25, 2017. Three days later, Defendant allegedly conducted internet searches regarding the stock prices of similar companies that had experienced data breaches. Less than an hour after conducting these searches, Defendant exercised all of his available stock options for Equifax securities and sold all of those shares for a profit of over $480,000. Nine days later, on September 7, 2017, Equifax publicly disclosed the data breach and Equifax's stock price dropped over 15 percent. On March 13, 2018, Defendant was indicted with two counts of securities fraud and insider trading. On June 11, 2018, Defendant filed a motion to dismiss the indictment, arguing that the indictment failed to allege that he possessed material nonpublic information and that he used such information when he traded.

The Court determined that the Government adequately alleged knowledge and use of material nonpublic information in its indictment against Defendant. First, the Court rejected Defendant's argument that he did not have knowledge of the material nonpublic information (here, the hacking and breach of Equifax's system) because he was not explicitly told of the breach. The Court held that it is well established that a defendant can be held liable for insider trading when he or she obtains and acts on fragments of information, then pieces them together to constitute material nonpublic information. Simply because Defendant figured out on his own that Equifax's entire databases had been hacked, is not a defense to trading on inside information. Second, the Court rejected Defendant's argument that the indictment was fatally flawed for failing to include the word "use" or the words "on the basis of" in the allegations. The Court noted that at this stage of the proceeding, the Government was not obligated to establish proof that Defendant in fact used the material nonpublic information while selling shares. However, a strong inference of use arises when an individual trades while in possession of material nonpublic information. According to the Court, the fact that Defendant used internet searches regarding the stock prices of other companies that had experienced data breaches before exercising all of his shares—a mere nine days before Equifax publicly disclosed the breach—was sufficient to allege "use" of material nonpublic information at the indictment stage of the proceeding. The Court went on to note that at trial, both parties would have the chance to establish sufficient evidence of use and to rebut said evidence.

United States v. Jun Ying, 2018 WL 6322308 (N.D. Ga. 2018).

Second Circuit Vacates Insider Trading Conviction and Remands, Holding Defendant's Intent in Providing Information to Father Not Clear for Tipper/Tippee Analysis

On November 5, 2018, the United States Court of Appeals for the Second Circuit vacated Defendant's conviction and remanded the case because the lower court failed to admit evidence that was directly relevant to the issue of whether Defendant had intended that his father would trade based on information Defendant gave him, in violation of Section 10(b) and Rule 10b-5 thereunder.

Defendant worked as an investment banker and was privy to material nonpublic information. During the course of his employment at first JP Morgan Chase and then at a smaller boutique investment bank, Defendant shared confidential information with his father. As the result of various investigations by FINRA and the SEC, Defendant's father was arrested and questioned by the FBI regarding his suspicious trades. On July 15, 2015, the Government filed an indictment charging Defendant and his father with conspiracy to commit securities fraud and tender offer fraud, conspiracy to commit wire fraud, tender offer fraud, and six counts of securities fraud. While Defendant's father pleaded to one count of conspiracy, his son's case proceeded to trial, where a jury convicted him of all counts. Before trial, Defendant moved to preclude introduction of a statement his father made to a friend in which he stated that Defendant told him "I handed you this on a silver platter and you didn't invest in this." The United States District Court for the Southern District of New York denied Defendant's motion, and this statement became the lynchpin of the Government's case against him. In an effort to counteract the effects of this statement, Defendant moved for leave to introduce his father's post-arrest statements to the FBI, in which he stated that Defendant really said "if you were trading—you could have made like millions of dollars." The District Court denied that motion as well, which led to Defendant's appeal.

The Second Circuit agreed with Defendant, finding that the District Court should have admitted his father's post-arrest statements, along with the "silver platter" statement. At issue in this case was whether or not Defendant intended that his father would trade on the confidential information he provided him. If he intended for his father to trade on that information, then a jury could reasonable find Defendant personally benefitted from the misappropriation of his employer's material nonpublic information. The Government focused on the "silver platter" statement throughout the trial, beginning opening statements with it and referring to the "silver platter" statement as "devastating" no fewer than three times in closing. The Second Circuit held that because this statement was essential to the Government's case, Defendant should have been permitted to admit his father's post-arrest statement to the FBI as evidence that Defendant had not engaged in improper tipper/tippee behavior. As the Second Circuit found that it was not harmless error for the District Court below to have omitted Defendant's father's post-arrest statement, it vacated the conviction and remanded the case for further determination.

United States v. Stewart, 907 F.3d 677 (2d Cir. 2018).

Middle District of North Carolina Finds No Scienter in Company CEO's Opinion Statements Regarding Pneumonia Drug's Clinical Trial Results

On October 26, 2018, the United States District Court for the Middle District of North Carolina dismissed a Putative Class Action suit brought against drug maker, Cempra Inc. ("Cempra"), by its shareholders ("Plaintiffs") alleging that Cempra made false and misleading statements regarding the safety profile of its drug, thereby allegedly artificially inflating the drug's stock price, because most of Cempra's statements were soundly based on clinical research results.

On November 4, 2016, Plaintiffs filed a Putative Securities Class Action Complaint, alleging that Cempra defrauded the class by making false and misleading statements about the safety profile of solithromycin, Cempra's lead product, which was developed for the treatment of community-acquired bacterial pneumonia. Plaintiffs alleged that Cempra failed to disclose issues related to liver injuries observed during the drug's clinical trials. Further, in a series of press releases, conference calls, and at health care conferences, Cempra's then-chief executive officer, Prabhavathi B. Fernandes, Ph.D. ("CEO") made positive statements related to her interpretations of clinical study results and the drug's safety. Ultimately, when the Food and Drug Administration ("FDA") published a report identifying instances of liver injury in connection with solithromycin, Cempra's stock price declined. Cempra moved to dismiss the complaint, asserting that Plaintiffs failed to meet the PSLRA's heightened pleading standards to give rise to a strong inference of scienter.

The Court held that the CEO's challenged statements of opinion were not actionable and were merely vague optimistic statements regarding the safety profile of the drug and therefore, the allegations were insufficient to establish a strong inference of scienter as is required under Rule 10b-5. In its finding, the Court stated that the clinical data provided the CEO with an objective source in which to base her opinion. The Court viewed the disparity in the FDA and Cempra's findings as a difference in opinion regarding the interpretation of the clinical results rather than Cempra's intent to deceive investors. Further, the Court cited Cempra's publicizing of the results of its trials in its 8-K, peer-reviewed scientific journals, and press releases in its rejection of Plaintiffs' scienter claim as they providence evidence of Cempra's disclosure of risks associated with its product, thereby evidencing the lack of an intent to deceive.

Hirtenstein v. Cempra, Inc., Fed. Sec. L. Rep. (CCH) P 100297, 2018 WL 5312783 (M.D. N.C. 2018).