

# Securities Regulation Law Journal

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# Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (April 1, 2019-June 30, 2019)

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, 2019 through June 30, 2019.*

The SEC finalized seven new rules for implementation and proposed three 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 increasing disclosure for retail investors in the brokerage context while streamlining and harmonizing certain compliance obligations in debt and equity capital markets. The key changes are summarized below.

## ***Final Rules***

### **Retail Investor Protections: Regulation Best Interest and Form CRS**

The SEC has adopted a new rule 15l-1 under the 1934 Act that will obligate broker-dealers to make investment recommendations in the best interests of retail customers. The enhanced standard of care draws from the Investment Advisers Act of 1940, as amended, (the "1940 Act") and the fiduciary standard applicable to investment advisers registered thereunder. However the SEC decided not to apply the 1940 Act to broker-dealers, opting instead to craft Regulation Best Interest as a new standard that would be less onerous than the fiduciary standard but would offer more protection to retail investors than they are afforded under the current quantitative suitability analysis. The new rule also fills the gap left 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

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or IRA plans and receive transaction-based compensation for their services.

In order to comply with Regulation Best Interest, 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. The SEC chose not to limit the scope of the definition to exclude high income or high net worth individuals from the ambit of Regulation Best Interest. The amendment seeks to balance the goals of providing retail investors with increased disclosure and protection from conflicts of interest with the desire of industry professionals to provide their customers access to a broad range of investment products.

In addition, the SEC finalized a new Form CRS (an acronym standing for “Client Relationship Summary”) and a related Amendment to Form ADV, complementing Regulation Best Interest by implementing additional disclosure requirements under the 1934 Act and the 1940 Act applicable to broker-dealers and investment advisors. Upon beginning a relationship with a new client, broker-dealers and investment advisors will be required to issue their retail customers<sup>1</sup> a new form disclosure 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. Firms will have discretion to draft their own responses to the questions in a manner that captures appropriate context and carries out the SEC’s disclosure goals. 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. Regulation Best Interest and the use of Form CRS will go into effect on September 10, 2019.

### **Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships**

The SEC amended its auditor independence definition under

Rule 2-01 of Regulation S-X to loosen certain restrictions on auditors when they have a lending relationship with a 10% or greater shareholder of an audit client or any entity controlling or under common control with the audit client (such rule, the “Loan Provision”). Previously, the SEC had imposed the 10% threshold under the Loan Provision as a bright-line rule; any auditor receiving a loan from a 10% or greater shareholder of an audit client or any entity controlling or under common control with the audit client was deemed no longer independent with respect to that client. The SEC recognizes that accounting firms often require financing to pay for expenses and labor prior to receiving payment for services. These borrowings are often held by commercial banks or other large lenders and may be syndicated to enhance diversification, thereby expanding the number of lenders of record to such firms. Especially in the context of auditing investment funds, the Loan Provision created onerous restrictions on audit firms and significant costs on Audit Committees responsible for examining each minor lending relationship that could give rise to a technical conflict. However, in most instances, such relationships do not create meaningful conflicts or impair the ability of auditors to fulfill their responsibility to investors. These conflicts may easily arise without the knowledge of a lender, auditor or audit client, creating significant diligence and compliance costs. In recognition of this reality, the SEC had issued a no-action letter to Fidelity in 2016 regarding audit firms that its affiliates had used that would not be in compliance with the Loan Provision. The SEC reported receiving many subsequent requests for no-action or further clarification on related questions.

Under the new rule, the Loan Provision has been scaled back in three material ways: (1) the 10% bright line has been replaced with a “significant influence” test based on the principles of ASC 323 (including its guidance that owning 20% or more of the securities of an entity creates a rebuttable presumption of significant influence); (2) a “known through reasonable inquiry” standard shall be applied with respect to identifying beneficial owners of the audit client’s equity securities; and (3) the definition of “audit client” was amended in the fund context to exclude certain affiliate funds of an audit client that would otherwise be picked up by the Loan Provision. In particular, the SEC clarified that financial intermediaries who have limited authority to make or direct voting or investment decisions shall not be deemed beneficial owners under the Loan Provision analysis. In the fund context, a fund investor having influence over a fund’s investment policies and day-to-day portfolio management would be deemed to have “significant influence.” The “known through reasonable inquiry” analysis is intended to reduce compliance costs and provide safe harbor where an ultimate beneficial owner cannot be discerned

through reasonable inquiry. Lastly, the amendment to the definition of “audit client” limits circumstances where an auditor could be deemed to lack independence to a broad range of entities in a fund context even where it does not audit many of those entities and where the investor it audits lacks the ability to influence the policies of the applicable fund. The amendment becomes effective October 3, 2019.

### ***Proposed Rules***

#### **Amendments to the Accelerated Filer and Large Accelerated Filer Definitions**

The SEC has proposed amending the accelerated filer and large accelerated filer definition to prevent most companies that qualify as smaller reporting companies (“SRCs”) from being subject to the requirements of accelerated filing status. Accelerated and large accelerated filers are subject to certain shorter filing periods for their periodic reports and are required to have an auditor attest to their internal control over financial reporting (“ICFR”). Smaller reporting companies are subject to reduced disclosure and compliance requirements meant to promote capital formation. On June 28, 2018, the SEC had expanded the definition of smaller reporting company to allow registrants with a public float under \$250 million or with zero public float but revenues below \$100 million (the prior applicable thresholds had been \$75 million and \$50 million, respectively) to qualify as SRCs. As a result of the rule change, some issuers qualified both as accelerated filers and smaller reporting companies despite having modest revenue, and were subject to two regimes at cross-purposes.

This proposed amendment addresses that incongruity by adding a condition to the accelerated and large accelerated filer definitions that stipulates an issuer is not eligible to be an accelerated filer if they qualify as an SRC under the SRC revenue test. Issuers that are eligible to be SRCs under the public float test and have a public float between \$75 million and \$250 million would remain accelerated filers if their annual revenue exceeds \$100 million. The SEC’s release includes the following chart that clarifies the proposed relationship:

<b>Proposed Relationships between SRCs and Non-Accelerated and Accelerated Filers</b>		
<b>Status</b>	<b>Public Float</b>	<b>Annual Revenues</b>
SRC and Non-Accelerated Filer	Less than \$75 million	N/A
	\$75 million to less than \$700 million	Less than \$100 million

<b>Proposed Relationships between SRCs and Non-Accelerated and Accelerated Filers</b>		
<b>Status</b>	<b>Public Float</b>	<b>Annual Revenues</b>
SRC and Accelerated Filer	\$75 million to less than \$250 million	\$100 million or more
Accelerated Filer (not SRC)	\$250 million to less than \$700 million	\$100 million or more

The rule change is designed to more carefully tailor the burden of ICFR audits required by the accelerated filer definition to companies with significant revenues that can support such disclosure.

Lastly, the proposed amendment would amend the transition thresholds for exiting accelerated filer and large accelerated filer status to set them at 80% of the initial thresholds to qualify, a treatment that already applies to the SRC thresholds. The exit thresholds are designed to prevent companies from toggling in and out of the applicable regime as a result of minor fluctuations in their public float. The amendment also includes the SRC revenue test exemption in the transition context, meaning that a company which was an accelerated filer but has revenues of less than \$80 million (80% of the applicable \$100 million threshold) will exit accelerated filer status and enter the SRC regime. The SEC has asked for comments to be submitted on or before July 29, 2019.

### ***On the Horizon***

#### **Private Offering Exemption Overhaul**

On June 18, 2019, the SEC issued a lengthy concept release requesting public feedback on potential streamlining of the various private placement primary offering exemptions, including Rules 506 and 504 of Regulation D, Regulation A, the intrastate offering exemption and Regulation Crowdfunding. Specifically, the SEC requested comment on gaps in the existing exempted offering framework, and whether the capital raising needs of particular industries or types of issuers are adequately addressed by current regulations. The SEC is also considering whether the existing latticework is overly complex, and could be simplified into a more streamlined set of exemptions. Cognizant of the increasing use of exempt offerings (under Rule 506 in particular), the SEC is also considering whether to open up access to accredited investor status (either by broadening the definition or creating an opt-in mechanism) in order allow more investors access to private placements. Nonetheless, the SEC wishes to balance its desire for investors to have access to markets against the pos-

sibility that increasing the proportion of exempt offerings may further chill registered offerings and public disclosure; to that end, they have also solicited comment on ways the exempt offering framework could be altered to help issuers transition to a registered public offering over time. The release is ambitious and open-ended, and has the potential to significantly affect the framework for financial and legal professionals in both private and public capital markets. The SEC has asked for comments to be submitted on or before September 24, 2019.

**NOTES:**

<sup>1</sup>The definition of retail customer applicable to this rule matches the definition in Regulation Best Interest, as described above.

## **Second Circuit Affirms Lower Court's Class Action Dismissal, Finding No Material Misstatements Concerning Company's Post-Acquisition Plans**

On April 29, 2019, the United States Court of Appeals for the Second Circuit affirmed the United States District Court for the Southern District of New York's dismissal of a Fourth Amended Complaint in a securities class action brought by Endo International PLC ("Endo") investors ("Plaintiffs") against Endo, holding that Endo's statements concerning its acquisition of another company and changes to come thereafter were not materially misleading and thus did not constitute fraud under Section 10(b) and Rule 10b-5 thereunder.

On May 25, 2016, Plaintiffs filed a Securities Class Action complaint on behalf of purchasers of Endo securities between March 2, 2015 and May 6, 2016, alleging that Endo defrauded the class by making false and misleading statements concerning its acquisition of Par Pharmaceutical Holdings Inc. ("Par") which allegedly left the investors with the false impression that Endo would not be making any drastic changes to its generics business, Qualitest Pharmaceuticals ("Qualitest"). Plaintiffs allege that Endo and several of its former and present executives (collectively, "Defendants"), executed a "secret plan" to transform Endo's generics business thereby abandoning Qualitest's business model in favor of Par's. Plaintiffs alleged that quarterly and annual reports, SEC filings, press releases and other statements and documents issued by Defendants did not disclose that changes to Endo's business, operations, and prospects were forthcoming. Plaintiffs allege that these omissions caused them to suffer losses as Endo's stock price fell \$11.32 per share, or 39.19%, between May 5, 2016 and May 9, 2016 after Endo filed its 8-K and issued a press release announcing its financial and operating results suffered a loss of \$0.40 per diluted share and changes to its board and management structure. On April 27, 2018 the United States Court for the Southern District of New York denied Plaintiffs' motions for relief and for leave to file a fourth amended complaint. Plaintiffs appealed.

The Second Circuit affirmed the lower court's decision, finding that the District Court correctly determined that Defendants had long indicated that they planned significant changes to Qualitest. The Court reasoned that when Endo announced its acquisition of

Par, it told investors that Par's CEO would lead the new combined generics business. Further, Endo disclosed that it was restructuring its generics business in its first 10-Q filed after closing of the Par deal. Defendants also repeatedly used the word "transformational" to describe the Par acquisition and the changes the acquisition would have on Endo's generics business model. The Court further reasoned that Endo's conveying to investors that it "did not intend to retain Qualitest's low-margin business model, instead favoring Par's focus on specialized, high barrier-to-entry products" warranted dismissal. The Second Circuit found that the Plaintiffs' Fourth Amended Complaint failed to plausibly allege that Defendants made any material misrepresentations in connection with the Par acquisition and in the absence of plausible 10b-5 violation, the amendment would be fruitless.

*Steamfitters' Industry Pension Fund v. Endo International PLC*, Fed. Sec. L. Rep. (CCH) P 100406, 2019 WL 1890764 (2d Cir. 2019).

### **Northern District of California Again Denies Class Certification, Holding That New Information is Not New and Not Sufficient to Show Scienter**

On May 24, 2019, the United States District Court for the Northern District of California denied plaintiffs' renewed motion for class certification in an action brought against Finisar Corporation ("Finisar") and its CEO (collectively, "Defendants") by its investors ("Plaintiffs"), alleging that statements made by the CEO unwarrantedly inflated Finisar's stock price to Plaintiffs' detriment.

On March 15, 2011, Plaintiffs filed a Putative Securities Fraud Class Action on behalf of all persons and entities who purchased or acquired Finisar's common stock between December 2, 2010 and March 8, 2011 (the "Class Period"), alleging that a statement made on December 2, 2010 by Finisar's then-CEO, Eitan Gertel, were materially misleading. On December 2, 2010 Gertel participated in a Credit Suisse Technology Conference call with analysts, media representatives, and investors during which he made a vague statement about customer inventory levels. During the call, an analyst mentioned that Finisar had "significantly outgrown" its end markets for the six quarters which preceded the Class Period and raised concerns regarding whether the company's growth was sustainable. When asked of Finisar's ability to sustain such growth, the CEO stated "if you look at the market, you see the fundamentals for growth are there . . . As far as we know we haven't seen any inventory issues with our product with our customers." Plaintiffs allege that the CEO's statement gave them a false sense of assurance. The same day

that the statement was made, Finisar's common stock increased \$3.29 per share, or 16.64% and continued to rise throughout the Class Period. Defendants rebutted Plaintiffs' allegations by presenting evidence indicating that the December 2<sup>nd</sup> statement had been made after the stock price had already increased from the previous day's close. On December 5, 2017, the United States District Court for the Northern District of California denied Plaintiffs' motion for class certification, ruling that Defendants successfully demonstrated that their statements did not have a major impact on Finisar's stock price due to the timing of the statement and the stock price's increase.

Upon Plaintiffs' renewed motion for class certification, the District Court found that a new expert report submitted by Plaintiffs did not consider Defendants' analyst's report showing that the allegedly fraudulent statements had no impact on Finisar's stock price. The court reasoned that although Plaintiffs' new evidence may have been newly procured, the evidence does not signify the emergence of new material facts. Therefore, in the absence of new material facts, Plaintiffs' motion for class certification was once again denied.

*In re Finisar Corporation Securities Litigation*, 2019 WL 2247750 (N.D. Cal. 2019).

### **Southern District of New York Grants Defendants' Motion to Dismiss, Finding Plaintiff Failed to Allege Fraud with Respect to Defendant's Statements**

On June 3, 2019, the United States District Court for the Southern District of New York granted defendants' motion to dismiss a Putative Class Action suit brought by Anton Colbert, Individually and on behalf of all others similarly situated ("Plaintiffs") against Defendants Rio Tinto plc and Rio Tinto Limited (collectively, "Rio Tinto"), an international mining group, and two of its former officers ("Defendant Executives"), holding that Plaintiffs failed to show scienter in four statements made by Defendants which allegedly evidence Defendants' desire to conceal its company's value.

On October 23, 2017, Colbert brought this Putative Class Action complaint individually and on behalf of all others similarly situated, alleging that Defendants made a number of misstatements and omissions of which Defendants had a duty to correct or update but failed to do so. In August 2011 Rio Tinto acquired Rio Tinto Coal Mozambique ("RTCM") premised on a project to increase Rio Tinto's production of coal, for \$3.7 billion. Soon after purchase, Rio Tinto ran into problems with the project concerning barging. Plaintiffs allege that by early 2012 Defendants knew that the problems would require Defendants to conduct an

impairment analysis, but Defendants failed to do so. In 2013, after concerns regarding the company's valuation were raised and impairment charges were realized Rio Tinto's stock price decreased.

The first alleged misstatement asserted by Plaintiffs was from a November 2012 regulatory filing which claimed that production at the Mozambican mine had "continued to ramp up." Plaintiffs allege that Defendants failed to disclose known problems while making this statement. Secondly, Plaintiffs found issue with statements made at a conference where Defendants touted its growth in Africa. Regarding these statements, the Judge found that Plaintiffs failed to identify that any of the named defendants contributed to the making of these statements. The third alleged misstatement came where a Defendant Executive failed to report problems with transporting coal via barging when responding to an investor's question about transporting coal in such a manner. The Court found that these statements were not misleading because they did not signify that barging was a practical or realistic option at that point, but rather that the Defendant Executive responded concerning rail transportation, which was still under consideration. With respect to the fourth statement the court found that even if the incorporation of the \$3.7 billion valuation was a misrepresentation, it was immaterial, therefore it dismissed this statement. Accordingly, the Court found that the Plaintiff's arguments fell short of alleging that Defendants acted with the requisite level of scienter.

Colbert v. Rio Tinto PLC, 2019 BL 203848 (S.D.N.Y. June 03, 2019).