# Annual Review of Federal Securities Regulation

*By the Subcommittee on Annual Review, Committee on Federal Regulation of Securities, ABA Section of Business Law**

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## I. Introduction

This Annual Review ("Review") was prepared by the Subcommittee on Annual Review of the Committee on Federal Regulation of Securities of the ABA Section of Business Law. The Review covers significant developments in federal securities law and regulation during 2012. The Review is divided into three sections: regulatory actions, accounting statements, and caselaw developments.

The Review is written from the perspective of practitioners in the fields of corporate and securities law. This results in an emphasis on significant developments under the federal securities laws relating to companies, shareholders, and their respective counsel. Our discussion is limited to those developments that are of greatest interest to a wide range of practitioners.

During 2012, the U.S. Securities and Exchange Commission (the "Commission") continued to devote its resources to rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Also, during 2012, the Commission focused on rulemaking required of it by the Jumpstart Our Business Startups Act, or JOBS Act, which was enacted in April 2012.[2] As a result, the regulatory section of this year's Review is organized in two parts, one focused on the final rules (proposed rules are not discussed) adopted by the Commission pursuant to the Dodd-Frank Act, and the second focused on the activities undertaken during 2012 by the Commission related to the JOBS Act. Generally, the Review does not discuss proposed regulations or rules that are narrowly focused, such as hedge fund and other private fund related rulemaking, or rulemaking related to registered investment companies or registered investment advisers. Given the significant time and attention devoted by the staff of the Commission to rulemaking required to be undertaken jointly by the Commission and the Commodity Futures Trading Commission to implement the derivative-market requirements of Title VII of the Dodd-Frank Act, the Review includes a brief summary of the principal final rules promulgated by the Commission related to security-based swaps. Cases are chosen for both their legal concepts as well as factual background. While the Subcommittee tries to avoid making editorial comments regarding regulations, rules, or cases, we have attempted to provide a practical analysis of the impact of the developments in the law and regulations on the day-to-day practice of securities lawyers.

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

2. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) [hereinafter JOBS Act].

# Regulatory Developments 2012

## I. Dodd-Frank Related Rulemaking

### A. Overview

Almost two-and-a-half years following the enactment of the Dodd-Frank Act,[1] the Commission is still working to finalize and adopt many of the required rules. During 2012, as discussed below, the Commission continued to make progress on Dodd-Frank Act implementation by finalizing rules related to corporate governance requirements, completing controversial rules requiring additional specialized corporate disclosures, releasing studies mandated by the Act regarding credit ratings, and, acting jointly with the Commodity Futures Trading Commission ("CFTC"), promulgating many of the critical rules relating to the regulation of derivatives.

### B. Corporate Governance Related Rules

Although the Dodd-Frank Act focuses principally on changes to the financial regulatory system, Title IX of the Dodd-Frank Act includes various corporate governance provisions that are applicable to public companies, regardless of industry.[2]

### C. Listing Standards for Compensation Committees

On June 20, 2012, the Commission adopted rules to implement the provisions of the Dodd-Frank Act that affect the composition of compensation committees, the use of compensation advisers by companies the securities of which are listed on national securities exchanges, and disclosure provided by companies regarding their use of compensation consultants.[3] Under the rules as adopted, the national securities exchanges are directed to adopt listing standards regarding the independence of members of compensation committees, as well as the independence of advisers engaged by compensation committees. Moreover, the rules require additional disclosure under Item 407 of Regulation S-K regarding any conflicts of interest arising from the work of compensation consultants.

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.) [hereinafter Dodd-Frank Act].
2. *See, e.g.*, *id.* §§ 951–957, 124 Stat. at 1899–1907 (codified in scattered sections of the U.S.C.) (Title IX–Subtitle E–Accountability and Executive Compensation).
3. Listing Standards for Compensation Committees, 77 Fed. Reg. 38422 (June 27, 2012) (to be codified at 17 C.F.R. pts. 229, 240).

### 1. Background

Section 952 of the Dodd-Frank Act added section 10C to the Securities Exchange Act of 1934, as amended (the "Exchange Act").[4] Exchange Act section 10C requires that the Commission direct the national securities exchanges to prohibit the listing of any company issuing equity securities, subject to limited exceptions, unless specific conditions are satisfied with respect to the authority of the compensation committee, the independence of the members of the compensation committee, and the consideration of specific factors relating to the independence of compensation advisers (e.g., consultants, legal counsel, and other advisers) retained by the compensation committee.[5] In response, the Commission adopted Exchange Act Rule 10C-1 to direct the national securities exchanges, including the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq"), to adopt listing standards regarding compensation committees and the compensation advisers that they retain.[6] In addition, pursuant to section 10C(c)(2) of the Exchange Act, the Commission amended its disclosure rules to require additional proxy statement disclosures regarding the retention of compensation consultants.[7]

### 2. Compensation Committee Independence Listing Standards

Under the Commission's new rules, the exchanges are directed to adopt listing standards that require each member of a compensation committee to be an independent member of the board of directors.[8] Neither the Dodd-Frank Act nor the Commission's final rules specifically define independence for this purpose; however, consistent with the Dodd-Frank Act, the rules adopted by national securities exchanges must consider:

- The sources of compensation of the director, including any consulting, advisory, or other compensatory fee paid by the company to the director;[9] and
- Whether the director is affiliated with the company or any of its subsidiaries or their affiliates.[10]

The Commission also has provided the exchanges with more discretion in setting the definition of independence than is currently available with respect

4. Dodd-Frank Act § 952, 15 U.S.C. § 78j-3 (Supp. V 2011).
5. *Id.*
6. Listing Standards for Compensation Committees, 77 Fed. Reg. at 38422. This approach is analogous to the implementation of corporate governance provisions of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), which required the Commission to promulgate rules that directed national securities exchanges to adopt certain corporate governance exchange listing standards. *See* Pub. L. No. 107-204, § 302, 116 Stat. 745, 777 (2002) (codified at 15 U.S.C. § 7241 (2006)).
7. Listing Standards for Compensation Committees, 77 Fed. Reg. at 38453–54 (to be codified at 17 C.F.R. § 229.407(e)(3)(iv)).
8. *Id.* at 38454 (to be codified at 17 C.F.R. § 240.10C-1(b)(1)).
9. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(1)(ii)(A)).
10. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(1)(ii)(B)).

to the independence of audit committee members as required pursuant to the Sarbanes-Oxley Act.[11] However, the Commission has not adopted any additional factors to be considered by the exchanges in establishing their listing standards.[12]

### 3. Compensation Committee Authority and Funding

Exchange Act Rule 10C-1 directs the exchanges to prohibit the listing of any equity security of an issuer that is not in compliance with the following standards:

- Each member of the compensation committee must be a member of the board of directors and must otherwise be independent;[13]
- The compensation committee, which for this purpose includes those members of the board of directors who oversee executive compensation matters on behalf of the board of directors in the absence of a board committee, must be directly responsible for the appointment, compensation, and oversight of the work of compensation consultants, independent legal counsel, and other advisers (collectively, "compensation advisers");[14]
- The compensation committee, in its sole discretion, must have authority to retain or obtain the advice of compensation advisers;[15]
- The issuer must provide the appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to the compensation advisers, if any;[16] and
- Before selecting any compensation adviser, the compensation committee must take into consideration the six independence criteria specified in Exchange Act Rule 10C-1(b)(4) (described below), as well as any additional factors specified in the listing criteria adopted by the exchanges.[17]

11. *See id.* at 38426. Section 301 of the Sarbanes-Oxley Act specifies that in order to be considered independent, a member of the audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee: (i) accept any consulting, advisory, or other compensatory fee from the company; or (ii) be an affiliated person of the company or any subsidiary thereof. *See* Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1(m)(3)(b) (2006).

12. For other purposes, companies generally ensure that compensation committee members are independent under different standards, such as those set forth in Exchange Act Rule 16b-3(b), 17 C.F.R. § 240.16b-3(b)(3) (2012) (for "non-employee directors") and in section 162(m) of the Internal Revenue Code of 1986, as amended, 26 U.S.C. § 162(m) (2006) (for "outside directors").

13. Listing Standards for Compensation Committees, 77 Fed. Reg. at 38454 (to be codified at 17 C.F.R. § 240.10C-1(b)(1)(i)).

14. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(2)(ii)).

15. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(2)(i)).

16. *Id.* at 38455 (to be codified at 17 C.F.R. § 240.10C-1(b)(3)).

17. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(4)).

The Commission made clear that these new rules do not require that the compensation committee act in accordance with the advice of compensation advisers or otherwise affect the ability or obligation of the compensation committee to exercise its own judgment.[18] Further, the rules and the resulting listing standards are not intended to preclude engaging non-independent legal counsel or obtaining advice from in-house or outside counsel retained by the company, although in the case of the latter, the compensation committee will still be required to conduct an independence assessment.[19]

### 4. Compensation Adviser Independence

Exchange Act Rule 10C-1 also directs the exchanges to adopt listing standards requiring that the compensation committee consider the independence factors specified in the rule, as well as any other relevant factors identified by the exchange, prior to engaging any compensation advisers.[20] The independence factors specified in Exchange Act Rule 10C-1 are

- The provision of other services to the company by the firm employing the compensation adviser;[21]
- The amount of fees received from the company by the firm employing the compensation adviser, as a percentage of that firm's total revenue;[22]
- The policies and procedures adopted by the firm employing the compensation adviser that are designed to prevent conflicts of interest;[23]
- Any business or personal relationship of the compensation adviser with a member of the compensation committee;[24]
- The compensation adviser's ownership of the company's stock;[25] and
- Any business or personal relationships between the company's executive officers and the compensation adviser or the firm employing the compensation adviser.[26]

### 5. Exemptions and Applicability of Listing Standards

In accordance with Exchange Act section 10C, the listing standards requirements regarding the independence of compensation committee members and

18. *Id.* at 38429.
19. *See id.*
20. Although the six factors must be considered prior to engaging a compensation adviser, a compensation committee need not consider the six independence factors before consulting with or obtaining advice from in-house counsel. *Id.* at 38455 (to be codified at 17 C.F.R. § 240.10C-1(b)(4) (Instruction to paragraph (b)(4)).
21. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(4)(i)).
22. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(4)(ii)).
23. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(4)(iii)).
24. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(4)(iv)).
25. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(4)(v)).
26. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(4)(vi)).

their compensation advisers do not apply to controlled companies,[27] smaller reporting companies,[28] or issuers of securities futures products cleared by a registered clearing agency or a clearing agency exempt from registration,[29] or registered clearing agencies that issue standardized options.[30] Exchange Act section 10C and the Commission's rules also exempt the following categories of companies from the independence requirement otherwise applicable to compensation committee members:

- Limited partnerships;[31]
- Companies in bankruptcy proceedings;[32]
- Open-end management investment companies registered under the Investment Company Act of 1940;[33] and
- Foreign private issuers that disclose annually why they do not have an independent compensation committee.[34]

While Exchange Act section 10C requires the Commission to permit an exchange to exempt a particular relationship from the compensation committee independence requirements,[35] the Commission itself did not adopt exemptions for any particular relationships. The Commission indicated that the exchanges should determine whether a particular relationship should be exempted.[36] Exchange Act section 10C and the Commission's rules also provide that exchanges are permitted to exempt any category of issuers, taking into consideration the size of the issuer, the potential impact of the requirements on smaller reporting issuers, and other relevant factors that are deemed appropriate, subject to review by the Commission.[37]

The Commission indicated that the listing standards apply to any committee of the board of directors overseeing a company's executive compensation, whether that committee is specifically designated as the compensation committee.[38] Exchange Act Rule 10C-1 also provides that, prior to delisting, a listed

27. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(5)(ii)). A "controlled company" is a listed company of which more than 50 percent of the voting power for the election of directors is held by an individual, a group, or another company. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(c)(3)).

28. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(5)(ii)).

29. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(5)(iii)).

30. *Id.* (to be codified at 17 C.F.R. § 240.10C-1(b)(5)(iv)).

31. Exchange Act § 10C(a)(1), 15 U.S.C. § 78j-3(a)(1) (Supp. V 2011); Listing Standards for Compensation Committees, 77 Fed. Reg. at 38454 (to be codified at 17 C.F.R. § 240.10C-1(b)(1)(iii)(A)(1)).

32. Exchange Act § 10C(a)(1), 15 U.S.C. § 78j-3(a)(1); Listing Standards for Compensation Committees, 77 Fed. Reg. at 38454 (to be codified at 17 C.F.R. § 240.10C-1(b)(1)(iii)(A)(2)).

33. Exchange Act § 10C(a)(1), 15 U.S.C. § 78j-3(a)(1); Listing Standards for Compensation Committees, 77 Fed. Reg. at 38454 (to be codified at 17 C.F.R. § 240.10C-1(b)(1)(iii)(A)(3)).

34. Exchange Act § 10C(a)(1), 15 U.S.C. § 78j-3(a)(1); Listing Standards for Compensation Committees, 77 Fed. Reg. at 38454 (to be codified at 17 C.F.R. § 240.10C-1(b)(1)(iii)(A)(4)).

35. Exchange Act § 10C(a)(4), 15 U.S.C. § 78j-3(a)(4) (Supp. V 2011).

36. Listing Standards for Compensation Committees, 77 Fed. Reg. at 38439.

37. Exchange Act § 10C(a)(4), 15 U.S.C. § 78j-3(a)(4); Listing Standards for Compensation Committees, 77 Fed. Reg. at 38454 (to be codified at 17 C.F.R. § 240.10C-1(b)(1)(iii)(B)).

38. *See* Listing Standards for Compensation Committees, 77 Fed. Reg. at 38448.

company has a reasonable opportunity to cure any defect regarding the independence of any compensation committee member.[39]

### 6. New Disclosures

As required by the Dodd-Frank Act, the Commission's new rules require enhanced disclosure regarding compensation consultants. Under the amendments to Item 407 of Regulation S-K, companies are now required to disclose whether the work of the compensation consultant has raised any conflict of interest and, if so, provide a description of the nature of the conflict of interest and how it is being addressed.[40] While the Commission has not defined what would constitute a conflict of interest, the new rules provide that the same six factors for considering consultant independence under Exchange Act Rule 10C-1 should be considered in determining whether a conflict of interest exists.[41]

As modified, the Commission's rules specify that, if a compensation committee retained or obtained the advice of a compensation consultant, the company is required to:

- Identify the compensation consultant;[42]
- State whether the consultant was engaged directly by the compensation committee (or another board committee performing equivalent functions);[43]
- Describe the nature and scope of the consultant's assignment and the material elements of the instructions or directions given to the consultant with respect to the performance of the consultant's duties under the engagement;[44] and
- Discuss whether the work of the consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.[45]

The expanded disclosure requirements will apply to proxy or information statements for an annual meeting of shareholders, or a special meeting in lieu of the annual meeting, at which directors will be elected occurring on or after January 1, 2013.[46]

In addition, to the extent that a compensation consultant that is advising the compensation committee or management on executive or director compensation

39. *Id.* at 38454 (to be codified at 17 C.F.R. § 240.10C-1(a)(3)).
40. *Id.* at 38453 (to be codified at 17 C.F.R. § 229.407(e)(3)(iv)).
41. *Id.* at 38453–54 (to be codified at 17 C.F.R. § 229.407(e)(3)(iv) (Instruction to Item 407(e)(3)(iv)) (cross-referencing 17 C.F.R. § 240.10C-1(b)(4)(i)–(vi))).
42. 17 C.F.R. § 229.407(e)(3)(iii) (2012).
43. *Id.*
44. *Id.*
45. Listing Standards for Compensation Committees, 77 Fed. Reg. at 38453 (to be codified at 17 C.F.R. § 229.407(e)(3)(iv)).
46. *Id.* at 38444.

matters also provides additional services in excess of $120,000 during the company's last completed fiscal year, then the company would need to disclose the aggregate fees for the executive or director compensation-related services and the aggregate fees for the additional services.[47]

### 7. Implementation by the Exchanges

On September 25, 2012, the NYSE and Nasdaq proposed listing standards to implement Exchange Act Rule 10C-1.[48] The NYSE essentially proposed standards that mirror the language of the Commission's final rules, which, in turn, closely tracked the language of section 952 of the Dodd-Frank Act.[49] Nasdaq followed suit, and like the NYSE, requires compensation committees to adopt charters.[50] However, Nasdaq added a few requirements, including that a director's receipt of compensation from a listed company—other than for board service—should constitute a bright-line prohibition against the director's service on the compensation committee.[51] In this respect, Nasdaq proposed the same standard that applies to audit committee members under Exchange Act Rule 10A-3, and as a result, prohibits a compensation committee member of a Nasdaq-listed company from accepting, directly or indirectly, any consulting, advisory, or other compensatory fee from the listed company or any subsidiary.[52]

NYSE-listed companies will have until their first annual meeting after January 15, 2014, or, if earlier, October 31, 2014, to comply with the compensation committee member independence standards.[53] Other standards, including the

47. *Id.* at 38442–43 (triggering 17 C.F.R. § 229.407(e)(3)(iii)(B)).

48. *See Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 1, Amending Sections 303A.00, 303A.02(a) and 303A.05 of the Exchange's Listed Company Manual to Comply with the Requirements of Securities and Exchange Commission Rule 10C-1, Exchange Act Release No. 68011*, U.S. Sec. & Exch. Comm'n (Oct. 9, 2012), http://www.sec.gov/rules/sro/nyse/2012/34-68011.pdf [hereinafter NYSE Proposal] (referring to notice given on September 25, 2012); *Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Proposed Rule Change to Modify the Listing Rules for Compensation Committees to Comply with Rule 10C-1 Under the Exchange Act and Make Other Related Changes, Exchange Act Release No. 68013*, U.S. Sec. & Exch. Comm'n (Oct. 9, 2012), http://www.sec.gov/rules/sro/nasdaq/2012/34-68013.pdf [hereinafter NASDAQ Proposal] (referring to notice given on September 25, 2012).

49. Dodd-Frank Act § 952, 15 U.S.C. § 78j-3 (Supp. V 2011).

50. *See* NYSE Proposal, *supra* note 48, at 7–8; NASDAQ Proposal, *supra* note 48, at 5.

51. NASDAQ Proposal, *supra* note 48, at 4.

52. *Id.* Similar to the standards for audit committees, indirect compensation would likely include amounts received by certain family members sharing a household and certain employees of the director. *Id.* at 10–11. However, the prohibition would not apply to board and committee fees and amounts received under a retirement plan for prior service with the listed company (provided that such compensation is not contingent on continued service) and there would be no look-back period with respect to compensation received by a director prior to his or her appointment. *Id.* at 10 & n.21.

53. *See Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Amendment No. 3, and Order Granting Accelerated Approval for Proposed Rule Change, as Modified by Amendment Nos. 1 and 3, to Amend the Listing Rules for Compensation Committees to Comply with Securities Exchange Act Rule 10C-1 and Make Other Related Changes, Exchange Act Release No. 68639*, U.S. Sec. & Exch. Comm'n, 55 (Jan. 11, 2013), http://www.sec.gov/rules/sro/nyse/2013/34-68639.pdf.

compensation committee adviser requirements and compensation committee charter requirements, become effective on July 1, 2013.[54]

Nasdaq's listing standards relating to the compensation committee responsibilities and authority and compensation committee adviser independence take effect on July 1, 2013, rather than immediately as proposed.[55] Conforming to the timeline imposed on NYSE-listed companies, the Commission provided that Nasdaq-listed companies would have until their first annual meeting after January 15, 2014, or, if earlier, October 31, 2014, to comply with the remaining provisions for compensation committees.[56]

### D. Specialized Disclosures

Title XV of the Dodd-Frank Act contains various provisions requiring public companies to make certain specialized disclosures.[57] During 2012, the Commission completed all of the required rulemakings under Title XV of the Dodd-Frank Act. These new disclosure requirements discussed below have proven to be quite controversial and are currently the subject of legal challenges.

#### 1. Conflict Minerals

Section 1502 of the Dodd-Frank Act amended the Exchange Act by adding section 13(p).[58] Through this newly created section, Congress sought to reduce the violent conflict in the Democratic Republic of Congo by stifling the ability of armed groups to finance their violent activities through the trade and exploitation of conflict minerals.[59] Section 13(p) directed the Commission to promulgate regulations that would require certain issuers to disclose information about their use of conflict minerals originating in the Democratic Republic of Congo or an adjoining country (collectively, "covered countries").[60]

On August 22, 2012, the Commission adopted Rule 13p-1 and created Form SD.[61] This rule implements a three-step process to determine whether an issuer

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54. *Id.* at 55 n.181.

55. *See Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment Nos. 1 and 2, and Order Granting Accelerated Approval of Proposed Rule Change as Modified by Amendment Nos. 1 and 2 to Amend the Listing Rules for Compensation Committees to Comply with Rule 10C-1 Under the Act and Make Other Related Changes, Exchange Act Release No. 68640*, U.S. Sec. & Exch. Comm'n, 18–19 & n.74 (Jan. 11, 2013), http://www.sec.gov/rules/sro/nasdaq/2013/34-68640.pdf.

56. *Id.* at 19–20 & n.78.

57. Dodd-Frank Act §§ 1501–1506, 124 Stat. at 2212–22 (codified in scattered sections of the U.S.C.).

58. Dodd-Frank Act § 1502(b), 15 U.S.C. § 78m(p) (Supp. V 2011).

59. Conflict Minerals, 77 Fed. Reg. 56274, 56275 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240 & 249).

60. *Id.* at 56276. For purpose of Rule 13p-1, the term "adjoining country" means "a country that shares an internationally recognized border with the Democratic Republic of the Congo." *Id.* at 56364 (to be reflected at Item 1.01(d)(1) of Form SD).

61. *Id.* at 56274 (to be codified at 17 C.F.R. §§ 240.13p-1, 249b.400). Form SD will not appear in the Code of Federal Regulations. *Id.* at 56362.

must disclose information about its use of conflict minerals.[62] First, an issuer must determine whether it meets the definitional requirements to be subject to this rule.[63] Second, a covered issuer must conduct a reasonable country of origin inquiry with respect to its necessary conflict minerals.[64] Finally, depending on the results of the inquiry, an issuer may also be required to exercise due diligence on the source and chain of custody of its necessary conflict minerals.[65] These steps—and the required disclosures—are detailed below.[66]

#### *a. "Conflict Minerals" Defined*

The Commission defined the term "conflict mineral" to include (i) columbite-tantalite (also known as coltan), cassiterite, gold, wolframite, or their derivatives tantalum, tin, and tungsten, or (ii) any other minerals or derivatives that the Secretary of State determines to be financing the conflict in the covered countries.[67] For purposes of meeting this definition, it makes no difference whether these minerals or derivatives finance or benefit an "armed group."[68]

#### *b. Issuers Covered by the Conflict Mineral Statutory Provisions*

In determining whether an issuer must disclose information or submit a report about its use of conflict minerals, the first step is to determine whether the requirements of Rule 13p-1 apply.[69] An issuer is subject to this rule where a conflict mineral is "necessary to the functionality or production" of a product "manufactured or contracted . . . to be manufactured" by the issuer.[70] Where an issuer does not meet this definition, it is not required to make any disclosures or to submit a report under Rule 13p-1.[71]

##### (i) Issuers that File Reports Under Section 13(a) or Section 15(d) of the Exchange Act

Rule 13p-1 only applies to issuers that file reports with the Commission under section 13(a) or section 15(d) of the Exchange Act, including domestic compa-

62. *Id.* at 56279.
63. *Id.* at 56279–80.
64. *Id.* at 56280–81.
65. *Id.* at 56281.
66. A flow chart summary of the application of the rule was prepared by the Commission and included in the adopting release. *See id.* at 56283.
67. *Id.* at 56364 (to be defined at Item 1.01(d)(3) of Form SD). Columbite-tantalite is the metal ore from which tantalum is extracted. *Id.* at 56283. Tantalum is commonly used in electronic components such as mobile telephones, computers, and digital cameras. *Id.* Cassiterite is the metal ore that is most commonly used to produce tin, which is used in alloys, plating, and solder. *Id.* Gold is commonly used for making jewelry and used in electronic, communication, and aerospace equipment. *Id.* Wolframite is the metal ore that is used to produce tungsten, which is commonly used for metal wires, electrodes, and contacts in lighting, electronic, electrical, heating, and welding applications. *Id.* at 56283–84.
68. *Id.* at 56285.
69. *Id.* at 56279.
70. *See id.* at 56362 (to be codified at 17 C.F.R. § 240.13p-1).
71. *Id.* at 56279.

nies, foreign private issuers, and smaller reporting companies (collectively "reporting issuers").[72] Registered investment companies are exempt from the disclosure and reporting requirements of this rule.[73] The Commission may temporarily exempt other issuers from this rule by revising or waiving the disclosure and reporting requirements, but only where the President determines that such an exemption is in the interest of national security.[74]

#### (ii) "Manufacture" and "Contract to Manufacture" Products

A reporting issuer must "manufacture" or "contract to manufacture" a product containing a conflict mineral to be subject to the requirements of Rule 13p-1.[75] While these concepts are not defined by the rule, the Commission has offered general guidance as to their meanings.[76]

##### *(a) "Manufacture"*

In declining to define "manufacture" for purposes of Rule 13p-1, the Commission indicated that this term should maintain—and be construed in accordance with—its generally understood meaning.[77] It clarified, however, that an issuer is not considered to "manufacture" a product where it only services, maintains, or repairs a product containing conflict minerals.[78]

##### *(b) "Contract to Manufacture"*

Additionally, the Commission indicated that whether an issuer "contracts to manufacture" a product depends on "the degree of influence [the issuer] exercises over the materials, parts, ingredients, or components to be included in [its] product that contains conflict minerals."[79] To fall within the meaning of this concept, an issuer is not required to request that a conflict mineral be included in a product.[80] However, an issuer is not considered to "contract to manufacture" a product where its actions involve nothing more than specifying or negotiating contractual terms with a manufacturer that do not directly relate to the manufacture of the product;[81] affixing its brand, marks, logo, or label to a generic product manufactured by a third party;[82] or servicing, maintaining, or repairing a product manufactured by a third party.[83]

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72. *Id.* at 56287 (to be codified at 17 C.F.R. § 240.13p-1).
73. *Id.* at 56301 n.298, 56362 (to be reflected at General Instruction C of Form SD).
74. Dodd-Frank Act § 1502(b), 15 U.S.C. § 78m(p)(3) (Supp. V 2011). Any such exemption may not exceed two years. *Id.*
75. Conflict Minerals, 77 Fed. Reg. at 56290.
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.* at 56291.
80. *Id.* at 56292.
81. *Id.* at 56291. Contract terms pertaining to training or technical support, price, insurance, indemnity, intellectual property rights, dispute resolution, or similar terms do not directly relate to the manufacturing of the product, unless taken to exercise a degree of influence over the manufacture of the product. *Id.*
82. *Id.*
83. *Id.*

*(c) Mining Issuers as "Manufacturing" Issuers*

The Commission also noted that an issuer that mines or contracts to mine conflict minerals is not considered to "manufacture" or "contract to manufacture" a product for purposes of Rule 13p-1.[84] However, a mining issuer will be included within the meaning of these concepts if it also manufactures or contracts to manufacture the product.[85]

### (iii) Conflict Minerals "Necessary" to a Product

A conflict mineral must be "necessary to the functionality or production" of a product for the manufacturing or contracting issuer to be subject to the requirements of Rule 13p-1.[86] The determination of whether a conflict mineral is "necessary" to a product depends on the facts and circumstances.[87] To assist in determining whether a conflict mineral is necessary to the functionality or production of a product, the Commission offered several factors to guide issuers.[88]

Specifically, an issuer should consider whether a conflict mineral is contained in and intentionally added to the product or any component of the product; whether a conflict mineral is necessary to the product's generally expected function, use, or purpose; and if a conflict mineral is incorporated for purposes of ornamentation, decoration, or embellishment, whether or not the primary purpose of the product is ornamentation or decoration.[89] Similarly, in determining whether a conflict mineral is "necessary to the production" of a product, an issuer should consider whether a conflict mineral is contained in the product and intentionally added in the product's production process and whether the conflict mineral is necessary to produce the product.[90]

*(a) Contained in the Product*

In determining whether a conflict mineral is "necessary to the functionality or production" of a product, an issuer should first consider whether the conflict mineral is actually contained in its product or a component of its product.[91] In fact, to be considered "necessary" for purposes of Rule 13p-1, the conflict mineral must actually be contained in the product or a component of the product.[92]

*(b) Intentionally Added*

Whether a conflict mineral is intentionally added to a product or production process—as opposed to being merely a naturally occurring byproduct—is a significant factor in determining whether a conflict mineral is "necessary" to a product.[93]

84. *Id.* at 56292.
85. *Id.*
86. *Id.* at 56362 (to be codified at 17 C.F.R. § 240.13p-1).
87. *Id.* at 56295.
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.* at 56295–96.
92. *Id.* at 56296.
93. *Id.*

In considering this factor, it makes no difference whether the conflict mineral was intentionally added to the product or production process by the issuer or a third party.[94]

#### (c) "Necessary to the Functionality"

To be considered "necessary to the functionality" of a product, a conflict mineral must be necessary to the product's generally expected function, use, or purpose.[95] In instances where a product has multiple generally expected functions, uses, and purposes, the conflict mineral need only be necessary for one such function, use, or purpose to be deemed "necessary" to the product as a whole.[96]

Additionally, where a conflict mineral is incorporated into a product for purposes of ornamentation, decoration, or embellishment, an issuer should consider whether the primary purpose of the product is ornamentation or decoration.[97] In fact, where a conflict mineral is incorporated into a product for purposes of ornamentation, decoration, or embellishment, it is more likely to be necessary to the functionality of a product where the primary purpose of the product is ornamentation or decoration rather than another purpose.[98]

#### (d) "Necessary to the Production"

To be considered "necessary to the production" of a product, a conflict mineral must be necessary to produce the product or a component of the product and must also be contained in a product.[99] If a conflict mineral is used in the production process as a catalyst or in a similar manner, it is only considered "necessary to the production" if it is actually contained in the product—or a component of the product—even if only in trace amounts.[100] A conflict mineral is not "necessary to the production" of a product where the conflict mineral is only contained in a physical tool or machine used to produce the product.[101] Similarly, where a conflict mineral is only contained in indirect equipment used to produce a product—such as computers and power lines—the product is not necessary for purposes of Rule 13p-1.[102]

#### (e) De Minimis Threshold

There is no exception that would prevent a product containing only a de minimis amount of necessary conflict mineral from triggering the disclosure and reporting obligations of this rule.[103]

94. *Id.*
95. *Id.* at 56297.
96. *Id.*
97. *Id.*
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.* at 56297–98.
102. *Id.* at 56298.
103. *Id.*

*(f) Prototypes and Demonstration Materials*

An issuer is not required to disclose information about the use of conflict minerals in materials, prototypes, and other demonstration devices containing or produced using conflict minerals because such items are not products.[104] However, once an issuer enters those items into the stream of commerce by offering them to a third party for consideration, the issuer must comply with the disclosure and reporting requirements of Rule 13p-1 for those products.[105]

*c. Location, Status, and Timing of Conflict Minerals Information*

Where a reporting issuer determines that its conflict minerals are necessary to the functionality or production of a product it has manufactured or contracted to be manufactured, Rule 13p-1 requires the issuer to disclose information about its use of conflict minerals and submit a specialized disclosure report to the Commission.[106] The Commission has offered general guidance for issuers pertaining to preparing and submitting the necessary conflict minerals information.[107]

### (i) Location of Conflict Minerals Information

A covered issuer is required to disclose information about its use of conflict minerals in a specialized disclosure report on the newly created Form SD.[108] Depending on the facts and circumstances surrounding a covered issuer, it must make the disclosures either in the body of Form SD under the heading "Conflict Minerals Disclosure" or in a Conflict Minerals Report attached as an exhibit to the form.[109]

### (ii) "Filing" of Conflict Minerals Information

A covered issuer is required to file—not merely furnish—Form SD with the Commission.[110] This obligation requires any Conflict Minerals Report and independent private sector audit reports also to be filed with the Commission.[111] A covered issuer must also make its Form SD—including its Conflict Minerals Report, if any—available on its internet website for a one-year period.[112]

### (iii) Uniform Reporting Period

A covered issuer must provide its annual conflict minerals information on a calendar-year basis, regardless of the issuer's fiscal year.[113] The specialized

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104. *Id.*
105. *Id.*
106. *Id.* at 56362 (to be codified at 17 C.F.R. § 240.13p-1).
107. *See generally id.* at 56298–310.
108. *Id.* at 56301.
109. *Id.* at 56301, 56363 (to be reflected at Item 1.01(c) of Form SD).
110. *Id.* at 56303 (to be codified at 17 C.F.R. § 240.13p-1). As such, any issuer may be held liable under section 18 of the Exchange Act where it knowingly provides misleading statements in its specialized disclosure report. *Id.* at 56304 & n.342.
111. *Id.* at 56303.
112. *Id.* at 56302 (to be reflected at Item 1.01(b)–(c) of Form SD).
113. *Id.* at 56305 (to be reflected at General Instruction B of Form SD).

disclosure report containing this information is due to the Commission on May 31 of the following year.[114]

#### (iv) Time Period for Providing Conflict Minerals Information

An issuer is required to disclose information about its use of conflict minerals in the calendar year in which the manufacture of the covered product is completed, regardless of whether the issuer manufactured or contracted to manufacture the product.[115] As such, where an issuer manufactures a product that utilizes a third party's component, which contains a conflict mineral, the issuer must provide the required information as part of the calendar year in which the manufacture of the product is ultimately completed.[116]

#### (v) Conflict Minerals Already in the Supply Chain

The disclosure obligations do not apply to any products made from conflict minerals that were "outside the supply chain" prior to January 31, 2013.[117] A conflict mineral is considered "outside the supply chain" after (i) any columbite-tantalite, cassiterite, and wolframite minerals or their derivatives have been smelted; (ii) any gold has been fully refined; or (iii) any other conflict minerals, or their derivatives, that have not been smelted or fully refined are located outside of the covered countries.[118]

#### (vi) Timing of Implementation

Rule 13p-1 does not provide a general delay of effectiveness for its disclosure and reporting requirements.[119] Instead, the first reporting period for all issuers will be from January 1, 2013, to December 31, 2013, with the first specialized disclosure reports being due to the Commission on or before May 31, 2014.[120]

### *d. Reasonable Country of Origin Inquiry and the Specialized Disclosures Report*

Once a reporting issuer determines that conflict minerals are necessary to the functionality or production of a product it manufactured or contracted to be manufactured, Rule 13p-1 requires the covered issuer to determine whether the necessary conflict minerals originated in the covered countries or came

114. *Id.*
115. *Id.*
116. *Id.* at 56306.
117. *Id.* at 56307.
118. *Id.* at 56307, 56364 (to be defined at Item 1.01(d)(7) of Form SD). These events mark the first opportunity in the supply chain that offers reliable proof that the conflict minerals will no longer benefit or finance armed groups. *Id.* at 56307.
119. *Id.* at 56309.
120. *Id.* In light of concerns about the feasibility of preparing the required disclosure given the early stages of the development of supply chain tracing mechanisms, the Commission provided a targeted, temporary provision intended to help issuers address some of the burdens and costs of complying with its rule. *Id.*; *see also infra* notes 155–57 and accompanying text (discussing "DRC conflict indeterminable").

from recycled or scrap sources.[121] In making this determination, a covered issuer must first conduct a reasonable country of origin inquiry.[122]

#### (i) Reasonable Country of Origin Inquiry

This inquiry must be reasonably designed to determine whether the issuer's necessary conflict minerals originated in the covered countries or came from recycled or scrap resources and must be executed in good faith.[123] Although this rule does not delineate any specific steps that are necessary for an issuer to satisfy this reasonable inquiry standard, the Commission has offered general guidance to issuers.[124]

The Commission indicated that an issuer would satisfy the reasonable inquiry standard if it "seeks and obtains reasonably reliable representations indicating the facility at which its conflict minerals were processed and demonstrating that those conflict minerals did not originate in the [c]overed [c]ountries or came from recycled or scrap sources."[125] An issuer may rely upon representations that come either directly from the facility at which the conflict minerals were processed or indirectly from some of the issuer's immediate suppliers in satisfying this standard.[126] The issuer must have a reason to believe that these representations are true and may not ignore any facts or circumstances that tend to indicate to the contrary.[127]

An issuer is not required to determine with certainty that its conflict minerals did not originate in the covered countries or did come from recycled or scrap sources.[128] Instead, the results of the reasonable country of origin inquiry determine the nature of an issuer's disclosures and whether it must exercise due diligence.[129] For example, if—as a result of its reasonable country of origin inquiry—an issuer (i) determines that its necessary conflict minerals did not originate in the covered countries or did come from recycled or scrap sources, or (ii) has no reason to believe that its necessary conflict minerals may have originated in the covered countries or reasonably believes that its necessary conflict minerals are from recycled or scrap sources, then the issuer is not required to exercise due diligence.[130] Instead, the issuer is only required to provide certain information about its conflict minerals in the body of its specialized disclosure report.[131]

121. *See* Conflict Minerals, 77 Fed. Reg. at 56310 (to be codified at 17 C.F.R. § 240.13p-1).

122. *Id*. Depending on the information revealed by the reasonable country of origin inquiry, an issuer may also be required to exercise due diligence on the source and chain of custody of its necessary minerals and provide a Conflict Minerals Report. *Id.*

123. *Id*. at 56312.

124. *Id*. The reasonableness of an inquiry will likely vary among issuers depending on their size, products, relationships with suppliers, and other factors. *Id.* at 56311–12.

125. *Id*. at 56312.

126. *Id*. The Commission does not require an issuer to receive representations from all of its suppliers regarding whether its conflict minerals originated in the covered countries or came from recycled or scrap sources. *Id.*

127. *Id.*

128. *Id*. at 56312–13.

129. *Id.*

130. *Id*. at 56313 (to be reflected at Item 1.01(b) of Form SD).

131. *Id.*

Conversely, if—as a result of its reasonable country of origin inquiry—an issuer (i) determines that its necessary conflict minerals did originate in the covered countries and did not come from recycled or scrap sources, or (ii) has reason to believe that its necessary conflict minerals may have originated in the covered countries and may not have come from recycled or scrap sources, then the issuer must exercise due diligence and may also be required to file a Conflict Minerals Report.[132]

#### (ii) Disclosures in the Body of the Specialized Disclosure Report

After making its reasonable country of origin inquiry, a covered issuer is required to make certain disclosures in the body of its specialized disclosure report if it (i) determines that its necessary conflict minerals did not originate in the covered countries or came from recycled or scrap sources, or (ii) has no reason to believe that its necessary conflict minerals originated in the covered countries or has reason to believe that its necessary conflict minerals are from recycled or scrap sources.[133] In these instances, the body of the specialized disclosure report must (i) disclose the issuer's determination, (ii) briefly describe the reasonable country of origin inquiry conducted by the issuer, and (iii) disclose the results of the reasonable country of origin inquiry.[134]

Additionally, an issuer is required to make certain disclosures in the body of its Form SD where—after exercising due diligence—the issuer determines that its conflict minerals did not come from the covered countries or did come from recycled or scrap sources.[135] In these instances, the issuer must (i) disclose the issuer's determination, (ii) briefly describe the reasonable country of origin inquiry and the due diligence efforts undertook in making this determination, and (iii) describe the results of the reasonable country of origin inquiry and due diligence efforts performed to demonstrate its belief that the conflict minerals did not originate in the covered countries or came from recycled or scrap sources.[136]

### *e. Due Diligence and Conflict Minerals Report*

An issuer is required to exercise due diligence on the source and chain of custody of its conflict minerals where—after its reasonable country of origin inquiry—it determines that its conflict minerals originated in the covered coun-

132. *Id.*
133. *Id.* at 56315.
134. *Id.* (to be reflected at Item 1.01(b) of Form SD). This information is designed to demonstrate the basis for an issuer's conclusion that it is not required to submit a Conflict Minerals Report. *Id.* Although the Commission does not require an issuer to maintain reviewable business records to support its conclusion that its conflict minerals did not originate in the covered countries based on its reasonable country of origin inquiry, maintenance of such records may be useful in demonstrating that an issuer fulfilled its obligations under the rule. *Id.* at 56316. Additionally, maintenance of such records may be required by the nationally or internationally recognized due diligence framework applied by the issuer. *Id.*
135. *Id.* at 56315.
136. *Id.* (to be reflected at Item 1.01(c) of Form SD).

tries and did not come from recycled or scrap sources, or had reason to believe that its minerals may have originated in the covered countries and may not have come from recycled or scrap sources.[137] Depending upon the results of its due diligence, an issuer may be required to make disclosures in the body of its Form SD or in a Conflict Minerals Report.[138]

In particular, where—as a result of its due diligence—an issuer (i) determines that its conflict minerals originated in the covered countries and did not come from recycled or scrap sources, or (ii) still has reason to believe that its minerals may have originated in the covered countries and may not have come from recycled or scrap sources, it is required to provide a Conflict Minerals Report.[139] Conversely, if an issuer determines that—as a result of its due diligence—conflict minerals did not originate in the covered country or determines that conflict minerals came from recycled or scrap sources, it is not required to file a Conflict Minerals Report but, instead, must make the disclosures in the body of its Form SD as described above.[140]

#### (i) Conflict Minerals Report

The Conflict Minerals Report is an issuer's determination of whether its products have or have not been found to be "DRC conflict free."[141] The information required to be included in an issuer's Conflict Minerals Report depends upon whether the issuer's products are or are not found to be "DRC conflict free."[142]

In circumstances where an independent private sector audit of a Conflict Minerals Report is required,[143] the Conflict Minerals Report must contain a certification that the issuer obtained such an audit.[144] This certification is merely a statement by the issuer that it obtained an independent private sector audit; however, it is not required to be signed by an officer of the issuer.[145] Furthermore, where an audit is conducted, a copy of the certified independent private sector audit must be included in the issuer's Conflict Minerals Report.[146]

Where an issuer's product is not found to be "DRC conflict free," the Conflict Minerals Report must include (i) a description of this product,[147] (ii) a description of the facilities used to process the necessary conflict minerals contained in this product,[148] (iii) the country of origin of those conflict minerals,[149] and

137. *Id.*

138. *Id.*

139. *Id.* at 56320 (to be reflected at Item 1.01(c) of Form SD).

140. *Id.* at 56315; *see supra* notes 133–36 and accompanying text.

141. Conflict Minerals, 77 Fed. Reg. at 56320.

142. *Id.* at 56363–64 (to be reflected at Item 1.01(c) of Form SD, which addresses the contents of the Conflict Minerals Report).

143. *See infra* Part I.D.1.e(iii)(c).

144. Conflict Minerals, 77 Fed. Reg. at 56320 (to be reflected at Item 1.01(c)(1)(ii)(B) of Form SD).

145. *Id.*

146. *Id.* (to be reflected at Item 1.01(c)(1)(ii)(C) of Form SD).

147. *Id.* at 56364 (to be reflected at Item 1.01(c)(2) of Form SD).

148. *Id.* The Commission believes the phrase "facilities used to process the conflict minerals," Dodd-Frank Act § 1502(b), 15 U.S.C. § 78m(p)(1)(A)(ii) (Supp. V 2011), refers to the smelter or refinery through which the issuer's minerals pass. Conflict Minerals, 77 Fed. Reg. at 56320.

149. Conflict Minerals, 77 Fed. Reg. at 56364 (to be reflected at Item 1.01(c)(2) of Form SD).

(iv) the efforts to determine the mine or location of origin with the greatest possible specificity.[150] A product that is found to be "DRC conflict free" is not required to be described in the Conflict Minerals Report but, instead, may be described in the issuer's Form SD as "DRC conflict free."[151]

A product may be described as "DRC conflict free" where the issuer determines that it does not contain a necessary conflict mineral that directly or indirectly finances or benefits armed groups in the covered countries, or determines that the necessary conflict mineral was obtained from a recycled or scrap source.[152] An issuer may not describe a product as "DRC conflict free" where—after exercising due diligence—the issuer is unable to determine that its conflict minerals (i) did not originate in the covered countries, (ii) did not directly or indirectly finance or benefit armed groups in covered countries, or (iii) came from recycled or scrap sources.[153] These products, therefore, must be designated as "not found to be 'DRC conflict free.'"[154]

Temporarily, however, an issuer that is unable to determine whether its products are or are not "DRC conflict free" may describe its products as "DRC conflict undeterminable."[155] This temporary designation is available to all issuers for the first two reporting cycles, and to all small reporting companies for the first four reporting cycles, after the effective date of this rule.[156] An issuer that describes its products as "DRC conflict undeterminable" is required to file a Conflict Minerals Report describing (i) its due diligence; (ii) the steps it has taken or will take, if any, since the end of the period covered in the most recent prior Conflict Minerals Report to mitigate the risk that its necessary conflict minerals benefit armed groups, including any steps to improve its due diligence; (iii) the country of origin of conflict minerals, if known; (iv) the facilities used to process the conflict minerals, if known; and (v) the efforts to determine the mine or location of origin with the greatest possible specificity, if applicable.[157]

150. *Id.* The Commission acknowledged that it is very difficult, if not impossible, to trace conflict minerals to their mine or other location after they have been initially smelted or refined other than through the smelter or refinery. *Id.* at 56321. In assisting in this determination, the State Department has produced "a map of mineral-rich zones, trade routes, and areas under the control of armed groups" in covered countries, and has developed guidance for commercial entities seeking to exercise due diligence on and formalize the origin and chain of custody of conflict minerals used in the products and by their suppliers. *Id.* at 56323. However, if, when the conflict minerals contained in those products are purchased and transported through the supply chain from the mine to the issuer, those conflict minerals do not directly or indirectly finance or benefit armed groups, the products are "DRC conflict free"—even if, at a later point in time, that supply chain becomes controlled by an armed group. *Id.* at 56324.

151. *Id.* at 56323 (to be reflected at Item 1.01(c)(2)(ii) of Form SD).

152. *Id.* at 56322–23.

153. *See id.* at 56323.

154. *See id.*

155. *Id.* at 56321 (to be reflected at Item 1.01(c)(1)(iii)–(iv) of Form SD). Upon the expiration of this temporary period, every such issuer being unable to determine whether or not its product qualifies as "DRC conflict free" will have to describe their products as having "not been found to be 'DRC conflict free.'" *Id.* at 5632 (to be reflected at Instruction (2) to Item 1.01 of Form SD).

156. *Id.* at 56321–22 (to be reflected at Instruction (2) to Item 1.01 of Form SD).

157. *Id.* at 56321 (to be reflected at Item 1.01(c)(1) of Form SD).

#### (ii) Due Diligence Standard

Where an issuer is required to exercise due diligence on the source and chain of custody of its conflict minerals, the Commission requires an issuer to follow a nationally or internationally recognized due diligence framework.[158] While this rule does not mandate a particular due diligence framework, the framework must have been established by a body or group that has followed due process procedures—including broad distribution of the framework for public comment—and be consistent with the criteria standards established by the U.S. General Accountability Office ("GAO").[159] The Commission has indicated that the only nationally or internationally recognized due diligence framework currently available for determining the source and chain of custody of conflict minerals is the framework approved by the Organisation for Economic Co-operation and Development ("OECD").[160] However, the Commission noted that it anticipates that other standards will likely develop over time.[161]

#### (iii) Independent Private Audit Requirements

Form SD requires a due diligence framework to include an independent private sector audit of the Conflict Minerals Report,[162] except where (i) the issuer's products are "DRC conflict undeterminable"; (ii) a nationally or internationally recognized due diligence framework does not exist for a necessary conflict mineral; or (iii) the issuer performed due diligence but determined that its necessary conflict minerals did not originate in the covered countries.[163]

##### *(a) Auditing Standards*

The GAO has indicated that it does not intend to develop new standards for an independent private sector audit of the Conflict Minerals Report.[164] As such, any audit of the Conflict Minerals Report will need to be conducted in accordance with the GAO's independence standards.[165]

158. *Id.* at 56326 (to be reflected at Item 1.01(c)(1)(i) of Form SD); *see also infra* Part I.D.1.e(iii)(d)(2) (discussing due diligence for whether conflict minerals are from recycled or scrap sources).

159. Conflict Minerals, 77 Fed. Reg. at 56326.

160. *Id.*

161. *Id.* Presently, it appears that the OECD provides the only nationally or internationally recognized due diligence framework for gold from recycled or scrap sources. *Id.* at 56333. However, neither the OECD nor any other body has a similar due diligence framework for cassiterite, columbite-tantalite, or wolframite from recycled or scrap sources. *Id.* The Commission noted that if a nationally or internationally recognized due diligence framework becomes available for such conflict minerals from recycled or scrap sources prior to June 30 of a calendar year, the first reporting period in which issuers must use the framework for that conflict mineral will be the subsequent calendar year. *Id.* However, if the due diligence framework is not approved until after June 30 of a calendar year, issuers are not required to use that framework for that conflict mineral until the second calendar year after approval to provide a full year before implementation. *Id.*

162. *Id.* at 56363 (to be reflected at Item 1.01(c)(1)(ii) of Form SD).

163. *Id.* at 56363–64 (to be reflected at Item 1.01(c)(1)(iv)–(vi) of Form SD).

164. *Id.* at 56328.

165. *Id.*

*(b) Auditor Independence*

The Commission did not adopt any additional independence requirements.[166] Therefore, any entities performing an independent private sector audit of the Conflict Minerals Report must comply with any independence standards established by the GAO.[167] This standard requires the auditor not to perform any other functions that may imperil independence, such as "management functions."[168] However, the Commission has acknowledged that it is not inconsistent with the independence requirement for an independent public accountant also to perform the independent private sector audit of the Conflict Minerals Report.[169]

*(c) Audit Objective*

The Commission designed the audit requirement to obtain an independent opinion or conclusion as to (1) whether the due diligence framework set forth in the Conflict Minerals Report materially conforms with the criteria set forth in the nationally or internationally recognized due diligence framework used by the issuer, and (2) whether the description of the due diligence measures the issuer performed are consistent with the due diligence process that the issuer undertook.[170] The audit objective is not to have an auditor express an opinion or conclusion as to whether the due diligence measures were effective or whether the issuer's necessary conflict minerals are "DRC conflict free."[171]

*(d) Recycled and Scrap Minerals*

According to the Commission, Congress intended to require disclosure regarding the use of conflict minerals that directly or indirectly financed or benefited armed groups.[172] Because conflict minerals obtained from recycled or scrap sources no longer finance or benefit armed groups, the Commission believes it is appropriate that all products with necessary conflict minerals from recycled or scrap sources be deemed "DRC conflict free."[173]

(1) Definition of "Recycled or Scrap Sources"

Conflict minerals are considered to be from "recycled or scrap sources" where "they are from recycled metals, which are reclaimed end-user or post-consumer

166. *Id.*
167. *Id.*
168. *Id.*
169. *Id.* However, the engagement to perform the independent private sector audit of the Conflict Minerals Report would nevertheless be considered a "non-audit service" subject to the pre-approval requirements of Rule 2-01(c)(7) of Regulation S-X, *id.* at 56328–29 (cross-referencing 17 C.F.R. § 210.2-01(c)(7)), and the disclosure requirements of Schedule 14A, *id.* at 56329 (cross-referencing 17 C.F.R. § 240.14a-101).
170. *Id.* at 56329.
171. *Id.* Notwithstanding this fact, the audit still provides investors and other users with the meaningful assurance that the issuer's due diligence framework is designed in conformity with the relevant nationally or internationally recognized framework and that the issuer is actually performing the due diligence measures that it represents that it performed. *Id.*
172. *Id.* at 56332.
173. *Id.* (to be reflected at Item 1.01(c)(2)(ii) of Form SD).

products, or scrap processed metals created during product manufacturing."[174] "Recycled metal" includes "excess, obsolete, defective, and scrap metal materials that contain refined or processed metals that are appropriate to recycle in the product of tin, tantalum, tungsten, and/or gold."[175] Minerals that are "partially processed, unprocessed, or a byproduct from another ore will not be included in the definition for recycled metal."[176]

(2) Due Diligence for Conflict Minerals that May Not Be from "Recycled or Scrap Sources"

The Commission requires an issuer to exercise due diligence as to whether its conflict minerals are from recycled or scrap sources if—after its reasonable country of origin inquiry—it determines or has reason to believe that its conflict minerals are not from recycled or scrap sources.[177] The issuer must exercise due diligence that conforms to a nationally or internationally recognized due diligence framework, if available.[178] The Commission noted that, at present, there is only one nationally or internationally recognized due diligence framework for determining whether conflict minerals came from recycled or scrap sources; however, this framework is only for recycled or scrap gold.[179] As such, until recycled and scrap sources frameworks are developed for the remaining conflict minerals, issuers using recycled or scraps of other conflict minerals must exercise due diligence without the benefit of a due diligence framework.[180] However, if a nationally or internationally recognized due diligence framework becomes available for any of the remaining recycled or scrap conflict minerals, issuers will be required to utilize that or any subsequent framework.[181]

*f. Severability of Rule 13p-1 and Form SD*

According to the Commission, if any provision of Rule 13p-1 or its application is held to be invalid, such invalidity shall not affect the other provisions that can be given effect without the invalid provision or application.[182] Similarly, if any portion of Form SD not related to the conflict minerals is held to be invalid, such invalidity shall not affect its use for purposes of disclosure pursuant to section 13(p) of the Exchange Act or Rule 13p-1.[183]

## 2. Disclosure of Payments by Resource Extraction Issuers

On August 22, 2012, the Commission adopted final rules pursuant to section 1504 of the Dodd-Frank Act requiring resource extraction issuers to disclose

174. *Id.* (to be reflected at Item 1.01(d)(6) of Form SD).
175. *Id.*
176. *Id.*
177. *Id.* at 56332 (to be reflected at Item 1.01(c) of Form SD).
178. *Id.* (to be reflected at Item 1.01(c)(1)(i) of Form SD).
179. *Id.* at 56333.
180. *Id.*
181. *Id.*; *see supra* note 161.
182. Conflict Minerals, 77 Fed. Reg. at 56333.
183. *Id.*

certain payments made to foreign governments or to the U.S. federal government for the purpose of commercial development of oil, natural gas, or minerals on Form SD to be filed on EDGAR with the Commission.[184]

The final rules apply to any "resource extraction issuer" that is defined to be any U.S. or foreign company that (i) is engaged in the commercial development of oil, natural gas, or minerals, and (ii) is required to file an annual report with the Commission, regardless of the size of the company or the extent of business operations constituting commercial development of oil, natural gas, or minerals.[185] The final rules contain no exemptions for foreign reporting issuers or smaller reporting companies.[186]

Commercial development of oil, natural gas, or minerals includes activities such as exploration, extraction, processing, and export, or the acquisition of license for any such activity.[187] Activities that are preparatory or ancillary, such as manufacturing products or equipment used to extract oil, natural gas, or minerals, are not intended to be covered by the final rules.[188]

A resource extraction issuer must disclose any payment that is (i) made to further the commercial development of oil, natural gas, or minerals, (ii) not de minimis (any payment or series of related payments of $100,000 or more), and (iii) categorized as taxes, royalties, fees, production entitlements, bonuses, dividends, or payments for infrastructure improvements.[189]

An affected resource extraction issuer must disclose certain payments that it, a subsidiary, or any other entity under its control made to a foreign government or to the U.S. government for the purpose of the commercial development of oil, national gas, or minerals.[190] Foreign government is defined broadly to include "a foreign national government as well as a foreign subnational government, such as the government of a state, province, county, district, municipality, or territory under a foreign national government."[191] A resource extraction issuer is required to determine whether it has control of an entity for purposes of the disclosure requirements based on a consideration of all relevant facts and

184. Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. 56365 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240 & 249). Section 1504 of the Dodd-Frank Act was enacted against a backdrop of international efforts seeking to promote accountability and transparency in countries dependent on the revenues from oil, gas, and mining. *Id.* at 56366. To accomplish this goal, Congress created a disclosure regime under the Exchange Act. Dodd-Frank Act § 1504, 15 U.S.C. § 78m(o) (Supp. V 2011).

185. Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. at 56371 (to be codified at 17 C.F.R. § 240.13q-1(b)(1)).

186. *See id.* at 56365.

187. *Id.* at 56417 (to be codified at 17 C.F.R. § 240.13q-1(b)(2)).

188. *Id.* at 56375.

189. Dodd-Frank Act § 1504, 15 U.S.C. § 78m(q)(1)(C) (Supp. V 2011) (defining "payment"); Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. at 56418–19 (to be reflected at Item 2.01(c)(6)–(7) of Form SD (defining "payment" and not "de minimis")).

190. Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. at 56418 (to be reflected at Item 2.01(a) of Form SD). The terms "subsidiary" and "control" have the meanings set forth in Rule 12b-2 under the Exchange Act. *Id.* at 56387 (cross-referencing 17 C.F.R. § 240.12b-2).

191. *Id.* at 56388 (to be reflected at Item 2.01(c)(2) of Form SD).

circumstances.[192] Certain payments made to the U.S. federal government must be disclosed; however, payments made to U.S. state and local governments need not be disclosed.[193]

Affected resource extraction issuers must file Form SD annually with the Commission and disclose the following items:

- Type and total amount of payments made for each project;
- Type and total amount of payments made to each government;
- Total amounts of payments, by category;
- Currency used to make the payments;
- Financial period in which the payments were made;
- Business segment of the resource extraction issuer that made the payments;
- The government that received the payments, and the country in which that government is located; and
- The project of the resource extraction issuer to which the payments relate.[194]

The final rules include an anti-evasion provision, which requires disclosure regarding any activity or payment that, although not in form or character within one of the categories specified under the rules, is nonetheless part of a plan or scheme to evade the disclosure requirements under section 13(q) of the Exchange Act.[195]

Affected issuers must comply with the final rules for fiscal years ending after September 30, 2013.[196] For the first report filed for fiscal years ending after September 30, 2013, a resource extraction issuer may be eligible to provide a partial

192. *Id.* at 56387.

193. *Id.* at 56389.

194. *Id.* at 56418 (to be reflected at Item 2.01(a)(1)–(8) of Form SD). The Commission left the term "project" undefined in order to provide resource extraction issuers flexibility in applying the term to different business contexts depending on factors such as the particular industry or business in which the resource extraction issuer operates as well as the size of such issuer. *Id.* at 56406. However, the final rules offer some guidance on what constitutes a "project." *Id.* Contractual arrangements with governments for the purpose of commercial development of oil, natural gas, or minerals typically define the relationship and payment flows between the resource extraction issuer and the government; these contracts generally provide a basis for determining the payments and required payment disclosure that would be associated with a particular "project." *Id.*

Information required to be disclosed must be included in an exhibit to Form SD and electronically tagged using the XBRL interactive data standard. Dodd-Frank Act § 1504, 15 U.S.C. § 78m(q)(2)(D)(ii) (Supp. V 2011); Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. at 56418 (to be reflected at Item 2.01(a) of Form SD). A separate ASCII or HTML exhibit is not required. *See* Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. at 56368.

195. Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. at 56376 (to be reflected at Instruction 9 to Item 2.01 of Form SD). For example, a resource extraction issuer could not avoid disclosure by re-characterizing an activity that would otherwise be covered under the final rules. *Id.*

196. *Id.* at 56365.

year report.[197] For any fiscal year beginning on or after September 30, 2013, a resource extraction issuer is required to file a report disclosing payments for the full fiscal year.[198] Item 2.01 of Form SD must be filed on EDGAR no later than 150 days after the end of the issuer's fiscal year.[199]

### E. Ratings

Title IX of the Dodd-Frank Act expands the Commission's oversight of credit rating agencies, and also requires that certain references to credit ratings in a broad range of regulations be replaced with alternative standards or measures of creditworthiness.[200] The Commission finalized a number of rules relating to credit rating agencies, including Rules 17g-1 through 17g-7 under the Exchange Act, which impose certain compliance requirements on rating agencies. The Commission also proposed a number of regulations that have yet to be finalized and adopted. As discussed below, in 2012, the Commission released several studies mandated by the Dodd-Frank Act.

#### 1. Extension of 17g-5 Relief

On November 26, 2012, the Commission announced that it would grant an additional temporary conditional exemption from the application of Rule 17g-5(a)(3)[201] under the Exchange Act, with respect to certain nationally recognized statistical rating organizations ("NRSROs").[202] Subparagraph (a)(3) of Rule 17g-5 requires an NRSRO—that is hired by an arranger to determine an initial credit rating for a structured finance product—to take certain steps designed to allow an NRSRO that is not hired by the arranger to nonetheless determine an initial credit rating—and subsequently monitor that credit rating—for the structured finance product.[203] In particular, under Rule 17g-5(a)(3), an NRSRO is prohibited from issuing or maintaining a credit rating when it is subject to certain conflicts of interest unless it has taken certain steps to disclose the conflict and established policies to manage conflicts in accordance with requirements set out in the Exchange Act.[204]

Originally, on May 19, 2010, the Commission conditionally exempted NRSROs from certain requirements in Rule 17g-5(a)(3) on May 19, 2010.[205]

197. *Id.*
198. *Id.*
199. *Id.* at 56418 (to be reflected at General Instruction B.2 of Form SD).
200. Dodd-Frank Act §§ 901–991, 124 Stat. at 1822–1955 (codified in scattered sections of the U.S.C.).
201. 17 C.F.R. § 240.17g-5(a)(3) (2012).
202. *Order Extending Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 Under the Securities Exchange Act of 1934 and Request for Comment, Exchange Act Release No. 68286*, U.S. Sec. & Exch. Comm'n (Nov. 26, 2012), http://www.sec.gov/rules/orders/2012/34-68286.pdf.
203. *See* 17 C.F.R. § 240.17g-5(a)(3) (2012).
204. *See id.*
205. *Order Granting Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 Under the Securities Exchange Act of 1934 and Request*

Pursuant to the original exemption, an NRSRO was not required to comply with Rule 17g-5(a)(3) until December 2, 2010, with respect to credit ratings where: (1) the issuer of the structured finance product was a non-U.S. person; and (2) the NRSRO had a reasonable basis to conclude that the structured finance product would be offered and sold upon issuance, and that any arranger linked to the structured finance product would effect transactions of the structured finance product after issuance only outside of the United States ("covered transactions").[206] On November 23, 2010, the Commission extended the conditional temporary exemption until December 2, 2011.[207] On November 16, 2011, the Commission extended the conditional temporary exemption until December 2, 2012.[208] The Commission has now extended the temporary conditional exemption that exempts NRSROs from complying with Rule 17g-5(a)(3) with respect to rating covered transactions until December 2, 2013, citing continued concerns about potential disruptions of local securitization markets.[209]

### 2. Ratings Study Required by Section 939(h) of the Dodd-Frank Act

In September 2012, the Commission staff released its report to Congress on credit rating standardization (the "Standardization Report"),[210] as required by section 939(h) of the Dodd-Frank.[211]

Section 939(h)(1) of the Dodd-Frank Act required the Commission to undertake a study on the feasibility and desirability of the following proposed changes:

- "standardizing credit rating terminology, so that all credit rating agencies issue credit ratings using identical terms";[212]
- "standardizing the market stress conditions under which ratings are evaluated";[213]

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*for Comment, Exchange Act Release No. 62120*, U.S. SEC. & EXCH. COMM'N (May 19, 2010), http://www.sec.gov/rules/exorders/2010/34-62120.pdf.

206. *Id.*

207. *Order Extending Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 Under the Securities Exchange Act of 1934 and Request for Comment, Exchange Act Release No. 63363*, U.S. SEC. & EXCH. COMM'N (Nov. 23, 2010), http://www.sec.gov/rules/other/2010/34-63363.pdf.

208. *Order Extending Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 Under the Securities Exchange Act of 1934 and Request for Comment, Exchange Act Release No. 65765*, U.S. SEC. & EXCH. COMM'N (Nov. 16, 2011), http://www.sec.gov/rules/other/2011/34-65765.pdf.

209. *Order Extending Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 Under the Securities Exchange Act of 1934 and Request for Comment, Exchange Act Release No. 68286*, U.S. SEC. & EXCH. COMM'N (Nov. 26, 2012), http://www.sec.gov/rules/orders/2012/34-68286.pdf.

210. U.S. SEC. & EXCH. COMM'N, REPORT TO CONGRESS: CREDIT RATING STANDARDIZATION STUDY (Sept. 2012) [hereinafter CREDIT RATING STANDARDIZATION STUDY], *available at* http://www.sec.gov/news/studies/2012/939h_credit_rating_standardization.pdf.

211. Dodd-Frank Act § 939(h), 124 Stat. at 1887.

212. *Id.* § 939(h)(1)(A), 124 Stat. at 1887.

213. *Id.* § 939(h)(1)(B), 124 Stat. at 1887.

- "requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress";[214] and
- "standardizing credit rating terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity."[215]

Based upon its own research and comments submitted by NRSROs, market participants, and others,[216] the Commission staff, as reflected in the Standardization Report, reached the following conclusions:

- Standardizing credit rating terminology may not be feasible because of "the number and uniqueness of rating scales and differences in credit rating methodologies used by credit rating agencies."[217] In addition, such standardization may "reduce incentives for credit rating agencies to improve their credit rating methodologies and surveillance procedures."[218]
- Standardizing market stress conditions under which ratings are evaluated may prevent the stress conditions from being tailored to a particular type of credit rating or being reevaluated and updated as needed.[219]
- Requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations is not feasible because the credit rating agencies provide credit ratings based on not only quantitative factors, but also various qualitative factors.[220]
- Although it is desirable to have standardized credit rating terminology across asset classes, some studies show that "credit ratings have not historically been comparable across asset classes."[221]

Given these factors, the Standardization Report recommends that the Commission "not take any further action at this time" to implement any proposed standardization.[222] Rather, the Report suggests the Commission focus on issuing new rules mandated under the Dodd-Frank Act to promote transparency relating to credit ratings and the methodologies used to determine those ratings.[223] In fact, in response to mandates contained in the Dodd-Frank Act,[224] the Commission recently proposed several rules requiring enhanced disclosure of the perfor-

214. *Id.* § 939(h)(1)(C), 124 Stat. at 1887.
215. *Id.* § 939(h)(1)(D), 124 Stat. at 1887.
216. Credit Rating Standardization Study, *supra* note 210, at 2.
217. *Id.* at 3.
218. *Id.*
219. *Id.*
220. *Id.*
221. *Id.* at 4.
222. *Id.* at 4, 44.
223. *Id.* at 4–5.
224. *See* Dodd-Frank Act § 932(a)(8), 15 U.S.C. § 78o-7(q)–(s) (Supp. V 2011).

mance of credit ratings and methodologies used to determine those ratings by NRSROs.[225]

### 3. Ratings Study Required by Section 939F of the Dodd-Frank Act

In December 2012, the Commission, as required by section 939F of the Dodd-Frank Act,[226] released its report to Congress on assigned credit ratings.[227] The report, also known as the "Franken Amendment Report," explores the credit rating process for structured finance products, conflicts of interest associated with the currently implemented "issuer-pay" and "subscriber-pay" models, and the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings for structured finance products.[228]

Pursuant to section 939F(b)(1), the Commission was required to carry out a study of the credit rating process for structured finance products and the conflicts of interest associated with the "issuer-pay" and the "subscriber-pay" credit rating models.[229] Under the "issuer-pay" model, the NRSRO receives payment for the initial and ongoing ratings of a security once a security is issued.[230] According to the Commission report, conflicts under this model arise because the NRSRO has an incentive to assign a higher credit rating in order to retain continued business from the issuer.[231] Under the "subscriber-pay" model, the subscribing issuer pays a subscription fee to the NRSRO for access to credit ratings.[232] This model also presents a conflict because the subscribing issuer may have an interest in the NRSRO determining or maintaining a particular credit rating.[233]

225. The proposed rules include: (1) amending the instructions for Exhibit 1 to Form NRSRO, which would require the NRSROs to "prescribe a standard definition of 'default' for purposes of the credit rating performance measurement statistics that applicants for registration as NRSROs and NRSROs must disclose in Exhibit 1," CREDIT RATING STANDARDIZATION STUDY, *supra* note 210, at 41; (2) adding new paragraph (b) to Rule 17g-7, which would require public disclosure of a broader scope of credit ratings and more information about a rating action, *id.*; (3) adding paragraph (a) of new Rule 17g-8, which would require an NRSRO to set up policies and procedures to ensure prompt disclosure of material changes to the procedures and methodologies used to determine credit ratings, the reason for those changes, and expected effect on credit ratings, *id.* at 42; (4) adding new paragraph (a) to Rule 17g-7, which would require an NRSRO to "publish a form containing information about the credit rating resulting from or subject to the rating action and any certification of a provider of third-party due diligence services received by the NRSRO that relates to the credit rating" when taking a rating action, *id.*; and (5) adding paragraph (b) of new Rule 17g-8, which would require an NRSRO to "establish, maintain, and enforce written policies and procedures" that: (a) assess the possibilities of an issuer's default; (b) "clearly define and disclose the meaning of any symbol used by the NRSRO to denote a credit rating"; and (c) ensure the symbol is used in a consistent manner, *id.* at 42–43.

226. Dodd-Frank Act § 939F(b)–(c), 15 U.S.C. § 78o-9(b)–(c) (Supp. V 2011).

227. U.S. SEC. & EXCH. COMM'N, REPORT TO CONGRESS ON ASSIGNED CREDIT RATINGS (Dec. 2012) [hereinafter REPORT ON ASSIGNED RATINGS], *available at* http://www.sec.gov/new/studies/2012/assigned-credit-ratings-study.pdf.

228. *Id.* at 1.

229. Dodd-Frank Act § 939F(b)(1), 15 U.S.C. § 78o-9(b)(1) (Supp. V 2011).

230. REPORT ON ASSIGNED RATINGS, *supra* note 227, at 12.

231. *Id.*

232. *Id.* at 16.

233. *Id.*

Under section 939F, the Commission is required to implement either an "issuer-pay" model or a "subscriber-pay" model unless it "determines an alternative system would better serve the public interest and the protection of investors."[234] Accordingly, the Commission staff, in its report, outlined the following credit rating alternatives, as well as the potential benefits and limitations associated with those alternatives:

- Implementation of the system established under section 15E(w) of the Exchange Act, which would require the Commission to: (1) establish a board to assign qualified NRSROs to rate structured finance products (the "CRA board"); (2) select initial members of the CRA board; and (3) establish a schedule to ensure that the CRA board begins assigning "Qualified NRSROs"[235] to provide initial ratings not later than one year after the selection of the members of the CRA board;[236]
- Implementation of enhancements to the program established under Rule 17g-5 of the Exchange Act,[237] which was intended to create a mechanism for an NRSRO that is not hired by an issuer to determine an initial credit rating at the same time the hired NRSRO makes such determination,[238] as well as provides a means to monitor the accuracy of the hired NRSRO's determination;[239] or
- Implementation of one or more of several alternative compensation models, including an investor-owned credit rating agency model.[240]

234. Dodd-Frank Act § 939F(d)(1), 15 U.S.C. § 78o-9(d)(1) (Supp. V 2011).

235. A "Qualified NRSRO" would be an NRSRO that the CRA board determines is qualified to issue initial credit ratings with respect to one or more categories of structured finance products. REPORT ON ASSIGNED RATINGS, *supra* note 227, at 28–29.

236. *Id.* at 28. The Commission was directed to "give thorough consideration to the provisions of section 15E(w) of the Securities Exchange Act of 1934, as that provision would have been added by section 939D of H.R. 4173 (111th Cong.), as passed by the Senate on May 20, 2010, and . . . to implement the system described in such section 939D of H.R. 4173 unless [it] determines that an alternative system would better serve the public interest and the protection of investors." Dodd-Frank Act § 939F(d)(1), 15 U.S.C. § 78o-9(d)(1) (Supp. V 2011). Such version of section 939D was never enacted by Congress. REPORT ON ASSIGNED RATINGS, *supra* note 227, at 2 n.9. Instead, the version of section 939D enacted by Congress directs the Comptroller General of the United States to conduct a study on the alternative means for compensating NRSROs in order to create incentives to provide more accurate credit ratings. Dodd-Frank Act § 939D, 15 U.S.C. § 78o-9 note (Supp. V 2011).

237. REPORT ON ASSIGNED RATINGS, *supra* note 227, at 59–62 (discussing potential enhancements to the existing program under 17 C.F.R. § 240.17g-5).

238. *Id.* at 54. In adopting the program established by Rule 17g-5, the Commission noted that when "an NRSRO is hired to rate a structured finance product, some of the information it relies on to determine the rating is generally not made public. As a result, structured finance products frequently are issued with ratings from only the one or two NRSROs that have been hired by the arranger, with the attendant conflict of interest . . . . [Rule 17g-5(a)(3) was] designed to increase the number of credit ratings extant for a given structured finance product and, in particular, to promote the issuance of credit ratings by NRSROs that are not hired by the arranger." *Id.* at 54 n.419 (quoting Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 63832, 63844 (Dec. 4, 2009)).

239. *Id.* at 54.

240. *Id.* at 62. The Commission staff addressed four alternative compensation models identified by the GAO: (1) the investor-owned credit rating agency model, (2) the stand-alone model, (3) the

The report recommends that the Commission convene a roundtable to discuss the study and its findings regarding the implementation of any of the foregoing alternatives.[241] Any further action by the Commission will require additional study of relevant information, including a cost benefit analysis and the consideration of public comment.[242]

## F. Derivatives Related Rules

The Dodd-Frank Act requires that the CFTC and the Commission work jointly to establish a new regulatory framework for the regulation of swaps and security-based swaps.[243] During 2012, the CFTC and the Commission finalized many of the most significant rules. The Dodd-Frank Act creates two new categories of market participants, swap dealers and major swap participants (and their securities-based counterparts, security-based swap dealers, and major security-based swap participants).[244] These terms are defined within the Dodd-Frank Act;[245] however, in April 2012, as discussed below, the CFTC and the Commission released final rules refining these definitions. Swap dealers and major swap participants must register with an applicable regulator and comply with rigorous internal and external business conduct standards. The Dodd-Frank Act creates parallel regulatory regimes for the CFTC and the Commission and divides jurisdiction between the two agencies based on whether a "swap" or a "security-based swap" is involved. The CFTC has jurisdiction over "swaps" and "swap dealers."[246] The Commission has jurisdiction over "security-based swaps" and "security-based swap dealers."[247] Final definitions for the terms "swap" and "security-based swap" also were adopted during 2012. Adoption of the final definitions for these products, and for the entities to be regulated, triggered numerous Dodd-Frank Act requirements relating to, among other things, registration and reporting requirements. The Commission also finalized rules establishing procedures for designating security-based swaps for clearing, as well as standards for clearing agencies. The CFTC and the Commission still have a substantial number of rules to implement under Title VII of the Dodd-Frank Act.[248] The summary that follows is a brief summary only, as a complete discussion of these issues is beyond the scope of the Review.

designation model, and (4) the user-pay model. *Id.* at 53. In addition, the Commission staff addressed three other alternative models: (1) the issuer and investor-pays model, (2) the alternative user-pays model, and (3) the investor-owned rating agency model. *Id.*

241. *Id.* at 73.

242. *Id.*

243. *See, e.g.*, Dodd-Frank Act § 712(d), 15 U.S.C. § 8302(d) (Supp. V 2011).

244. *See, e.g.*, *id.* § 731, 7 U.S.C. § 6s (Supp. V 2011); *id.* § 764, 15 U.S.C. § 78o-8 (Supp. V 2011).

245. *Id.* § 721(a), 7 U.S.C. § 1a(32), (33), (43), (49) (Supp. V 2011).

246. *See, e.g.*, *id.* § 731, 7 U.S.C. § 6s.

247. *See, e.g.*, *id.* § 764, 15 U.S.C. § 78o-8 (Supp. V 2011).

248. *Id.* §§ 701–774, 124 Stat. at 1641–1802 (codified in scattered sections of the U.S.C.).

### 1. Requirements and Process for Mandatory Clearing of Swaps and Security-based Swaps

The Commission released final rules under the Securities Act of 1933, as amended (the "Securities Act"), the Exchange Act, and the Trust Indenture Act of 1939, as amended (the "Trust Indenture Act"), exempting security-based swaps issued by certain clearing agencies from provisions of those acts.[249] The rules became effective on April 16, 2012, replacing all prior temporary rules.[250]

Title VII of the Dodd-Frank Act amended the Exchange Act to require, among other things, that: (1) a transaction in a security-based swap must be submitted for clearing to a clearing agency if such security-based swap is one that the Commission has determined is required to be cleared, unless an exception from mandatory clearing applies;[251] (2) a transaction in a security-based swap must be reported to a registered security-based swap data repository or the Commission;[252] and (3) if a security-based swap is subject to mandatory clearing, a transaction in the security-based swap must be executed on an exchange or a registered or exempt security-based swap execution facility ("security-based SEF"), unless no exchange or security-based SEF makes such security-based swap available for trading or the security-based swap transaction is subject to the clearing exception contained in section 3C(g) of the Exchange Act.[253]

### 2. Exemption from Securities Act Registration—Securities Act Rule 239

Rule 239 exempts the offer or sale of a security-based swap from all provisions of the Securities Act other than the anti-fraud provisions of section 17(a), subject to certain conditions.[254] The exemption is available for all security-based swaps that are or will be issued to eligible contract participants[255] by, and in transactions involving, a clearing agency in its role as a central counterparty ("CCP") that is either registered under section 17A of the Exchange Act or exempt from such registration.[256] The exemption is applicable if the Commission has determined that the security-based swap is required to be cleared, or the registered or exempt CCP is permitted to clear it pursuant to its rules.[257] The following

249. Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, 77 Fed. Reg. 20536, 20536 (Apr. 5, 2012) (to be codified at 17 C.F.R. pts. 230, 240 & 260).

250. *Id.*

251. *See* Dodd-Frank Act § 763(a), 15 U.S.C. § 78c-3 (Supp. V 2011).

252. *See id.* §§ 763(i), 766(a), 15 U.S.C. §§ 78m(m)(1)(G), 78m-1(a)(1) (Supp. V 2011).

253. *See id.* § 763(a), 15 U.S.C. § 78c-3 (Supp. V 2011); *see also id.* § 761(a), 15 U.S.C. § 78c(a)(77) (Supp. V 2011) (defining the term "security-based swap execution facility"); Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (proposed Feb. 28, 2011) (to be codified at 17 C.F.R. pts. 240, 242 & 249).

254. Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, 77 Fed. Reg. at 20549 (to be codified at 17 C.F.R. § 230.239).

255. The term "eligible contract participant" is defined by reference to section 1a(18) of the Commodity Exchange Act. Dodd-Frank Act § 711, 7 U.S.C. § 1a(18) (Supp. V 2011).

256. Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, 77 Fed. Reg. at 20549 (to be codified at 17 C.F.R. § 230.239(a)(1)).

257. *Id.* (to be codified at 17 C.F.R. § 230.239(a)(2)).

information is required to be included with the agreement the clearing agency provides to its counterparty or posts to a publicly available website:

- A statement identifying any security, issuer, loan, or narrow-based security index underlying the security-based swap;[258]
- A statement indicating the security or loan to be delivered (or class of securities or loans), or if cash settled, the security, loan, or narrow-based security index (or class of securities or loans) the value of which is to be used to determine the amount of the settlement obligation under the security-based swap;[259] and
- A statement of whether the issuer of any security or loan, each issuer of a security in a narrow-based security index, or each referenced issuer underlying the security-based swap is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act and, if not subject to such reporting requirements, whether public information, including financial information, about any such issuer is available and where the information is available.[260]

With respect to eligibility to enter into security-based swaps, the Dodd-Frank Act added a new subsection to section 5 of the Securities Act, which provides that it is unlawful to offer to buy, purchase, or sell a security-based swap to any person that is not an eligible contract participant, unless the transaction is registered under the Securities Act.[261] The Commission promulgated new Rules 12a-10 and 12h-1(h) under the Exchange Act, which provide for exemptions from registration that are tied to the eligibility requirements of the new subsection added to section 5 of the Securities Act.[262]

### 3. Exemptions from Exchange Act Registration—Exchange Act Rule 12a-10 and 12h-1(h)

Rule 12a-10 exempts security-based swaps from the registration requirements of section 12(a) of the Exchange Act.[263] Section 12(a) of the Exchange Act makes it unlawful to sell a security on a national exchange unless the security has been registered under section 12(b) of the Exchange Act for trading on that exchange.[264] The exemption in Rule 12a-10 applies to security-based swaps that are issued by a registered or exempt CCP.[265] The security-based swap must be one that the Commission has determined is required to be cleared pursuant

258. *Id.* (to be codified at 17 C.F.R. § 230.239(b)(3)(i)).
259. *Id.* (to be codified at 17 C.F.R. § 230.239(b)(3)(ii)).
260. *Id.* (to be codified at 17 C.F.R. § 230.239(b)(3)(iii)).
261. Dodd-Frank Act § 768(b), 15 U.S.C. § 77e(e) (Supp. V 2011).
262. Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, 77 Fed. Reg. at 20549 (to be codified at 17 C.F.R. §§ 240.12a-10, 240.12h-1(h)).
263. *Id.* (to be codified at 17 C.F.R. § 240.12a-10).
264. 15 U.S.C. § 78*l*(a) (2006).
265. Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, 77 Fed. Reg. at 20549 (to be codified at 17 C.F.R. § 240.12a-10(a)).

to such CCP's rules, sold to an eligible contract participant in reliance on Rule 239, and traded on a national exchange that is registered pursuant to section 6(a) of the Exchange Act.[266]

Rule 12h-1(h) exempts from the registration requirements of section 12(g) of the Exchange Act security-based swaps that are issued by a registered or exempt CCP.[267] Section 12(g) requires an issuer with more than $10 million in total assets and a class of equity securities held by 500 or more persons to register with the Commission.[268] To qualify for the Rule 12h-1(h) exemption, security-based swaps must be issued by a registered or exempt CCP, be required or permitted to be cleared pursuant to such CCP's rules, and be sold to eligible contract participants.[269] Security-based swaps that are not cleared through a registered or exempt CCP, but are listed on a national securities exchange, will not be able to rely upon the exemptions from sections 12(b) or 12(g) of the Exchange Act.[270]

### 4. Trust Indenture Act Exemption—Rule 4d-11

Rule 4d-11 under section 304(d) of the Trust Indenture Act exempts any security-based swap offered and sold in reliance on Rule 239 under the Securities Act from having to comply with the provisions of the Trust Indenture Act.[271]

### 5. Entity Definitions

On April 27, 2012, the CFTC and the Commission jointly adopted final rules to define "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant."[272] Those whose swap dealing activities exceeded the applicable de minimis threshold, as discussed below, after October 12, 2012, were required to register with the CFTC (through the National Futures Association) on or before December 31, 2012,[273] and the first major swap participants were required to register on or before February 28, 2013.[274] Registration is not yet required for security-

266. *Id.* (to be codified at 17 C.F.R. § 240.12a-10(b)–(d)).

267. *Id.* (to be codified at 17 C.F.R. § 240.12h-1(h)).

268. 15 U.S.C. § 78*l*(g) (2006); 17 C.F.R. § 240.12g-1 (2012). Congress amended section 12(g) of the Exchange Act so that registration is generally required of an issuer with more than $10 million in assets and a class of equity security held of record by either 2,000 persons or 500 persons who are not accredited investors. *See infra* notes 456–64 and accompanying text.

269. Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, 77 Fed. Reg. at 20549 (to be codified at 17 C.F.R. § 240.12h-1(h)).

270. *See id.* at 20545, 20549.

271. *Id.* at 20544 (to be codified at 17 C.F.R. § 260.4d-11).

272. Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012) (to be codified at 17 C.F.R. pts. 1 & 240) [hereinafter Further Definitions].

273. *See* Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Staff Responds to Questions on Timing of Swap Dealer Registration Rules (Sept. 10, 2012), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6348-12.

274. Further Definitions, *supra* note 272, 77 Fed. Reg. at 30747, 30754 (to be codified at 17 C.F.R. §§ 1.3(hhh)(3) (requiring registration "two months after the end" of the applicable quarter),

based swap dealers or major security-based swap participants. In the future, as other entities' dealing activities surpass the applicable de minimis thresholds, or their swap or security-based swap positions cross the applicable thresholds, they will be required to register with the CFTC or the Commission, as applicable.

*a. Definition of Swap Dealer or Security-Based Swap Dealer*

"Swap dealer" and "security-based swap dealer" are defined similarly. Swap dealer is defined under section 1a(49) of the Commodity Exchange Act ("CEA") and 17 C.F.R. § 1.3(ggg).[275] Security-based swap dealer is defined in section 3(a)(71) of the Exchange Act and 17 C.F.R. § 240.3a71-1.[276] In general, a "swap dealer" or "security-based swap dealer" means an entity that:

- Holds itself out as a dealer in swaps or security-based swaps;
- Makes a market in swaps or security-based swaps;
- Regularly enters into swaps or security-based swaps with counterparties in the ordinary course of business[277] for its own account; or
- Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.[278]

The rules additionally include a requirement that an entity be acting as part of a regular business in order to be considered a swap dealer or security-based swap dealer.[279]

Certain swaps are not considered in the determination of whether an entity is a swap dealer or security-based swap dealer.[280] In particular, for purposes of determining whether an entity is a swap dealer, certain swaps are excluded, such as certain swaps entered into by insured depository institutions in connection with originating loans to customers, certain swaps between majority-owned affiliates, certain swaps entered into by a cooperative with its members, certain swaps entered into for hedging physical positions,[281] and certain swaps entered into

240.3a67-8 (requiring registration "two months after the end" of the applicable quarter for major security-based swap participant)).

275. 7 U.S.C. § 1a(49) (Supp. V 2011); Further Definitions, *supra* note 272, 77 Fed. Reg. at 30744 (to be codified at 17 C.F.R. § 1.3(ggg)).

276. 15 U.S.C. § 78c(a)(71) (Supp. V 2011); Further Definitions, *supra* note 272, 77 Fed. Reg. at 30755 (to be codified at 17 C.F.R. § 240.3a71-1).

277. One is not a swap dealer if, for example, one enters swaps "not as a part of a regular business." Further Definitions, *supra* note 272, 77 Fed. Reg. at 30598 (to be codified at 17 C.F.R. §§ 1.3(ggg)(2), 240.3a71-1(b)). The terms "ordinary course of business" and "regular business" are to be considered synonyms for the purposes of the definition of swap dealer. *Id.*

278. *Id.* at 30597 (to be codified at 17 C.F.R. §§ 1.3(ggg)(1)(i)–(iv), 240.3a71-1(a)(1)–(4)).

279. *See supra* note 277.

280. Further Definitions, *supra* note 272, 77 Fed. Reg. at 30745–46, 30756 (to be codified at 17 C.F.R. §§ 1.3(ggg)(5)–(6), 240.3a71-1(d)).

281. Entering into a swap for bona fide hedging purposes is inconsistent with swap dealing, but due to uncertainties, such as the difficulty in distinguishing a swap with a bona fide hedging purpose from a swap with a hedging consequence, the CFTC adopted an interim final rule regarding hedging. *See id.* at 30611–12 (to be codified at 17 C.F.R. § 1.3(ggg)(6)(iii)).

by registered floor traders.[282] In determining whether one is a security-based swap dealer, one's security-based swaps with a majority-owned affiliate are not considered.[283]

The volume of swap dealing is also a consideration in determining whether a person is a swap dealer or a security-based swap dealer. The Commission and the CFTC have established a "phase-in" period for the time immediately after the effective date of the rules, which has higher de minimis thresholds than after the phase-in period ends.[284] The phase-in period termination date will be determined at a later date by the Commission and the CFTC.[285] Generally, an entity has two months to register as a swap dealer or security-based dealer following the end of the month in which it surpasses the applicable de minimis threshold.[286]

An entity shall not be considered a swap dealer if such entity and its affiliates do not exceed $3 billion in swap positions during the immediately preceding twelve-month period, subject to a phase-in period threshold of $8 billion.[287] The threshold for swap dealing with certain "special entities"[288]—such as municipalities, endowments, and employee benefit plans—is $25 million over the preceding twelve-month period.[289]

An entity shall not be considered a security-based swap dealer if such entity and its affiliates do not exceed $150 million in security-based swap positions during the preceding twelve-month period, subject to a phase-in level of $400 million.[290] With regard to credit default swaps that constitute security-based swaps, the Commission set an aggregate gross notional amount of no more than $3 billion during the preceding twelve-month period, subject to a phase-in amount of $8 billion.[291] Security-based swaps with special entities are subject to a $25 million threshold in the preceding twelve-month period.[292]

Both the CEA and Exchange Act provide that the CFTC and the Commission may designate an entity as a dealer for one type, class, or category of swap or security-based swap, or related activities, without the entity being considered a dealer for other types, classes, categories, or activities.[293] Absent a limited purpose designation, an entity that is a swap dealer (or security-based swap dealer) would be deemed to be a swap dealer (or security-based swap dealer) for each swap (or security-based swap) it entered into, regardless of the type, class, or category of swap (or security-based swap) or the entity's activities in connection

282. *Id.* at 30745–46 (to be codified at 17 C.F.R. § 1.3(ggg)(5)–(6)).
283. *Id.* at 30756 (to be codified at 17 C.F.R. § 240.3a71-1(d)(1)).
284. *Id.* at 30745, 30756 (to be codified at 17 C.F.R. §§ 1.3(ggg)(4)(ii), 240.3a71-2(a)(2)).
285. *Id.* at 30745, 30756 (to be codified at 17 C.F.R. §§ 1.3(ggg)(4)(ii)(A)–(D), 240.3a71-2(a)(2)(ii)).
286. *Id.* at 30745, 30756 (to be codified at 17 C.F.R. §§ 1.3(ggg)(4)(iii), 240.3a71-2(b)).
287. *Id.* at 30744 (to be codified at 17 C.F.R. § 1.3(ggg)(4)).
288. *Id.* at 30626 n.368.
289. *Id.* at 30744 (to be codified at 17 C.F.R. § 1.3(ggg)(4)).
290. *Id.* at 30756 (to be codified at 17 C.F.R. § 240.3a71-2(a)(ii)).
291. *Id.* (to be codified at 17 C.F.R. § 240.3a71-2(a)(i)).
292. *Id.* (to be codified at 17 C.F.R. § 240.3a71-2(a)(iii)).
293. 7 U.S.C. § 1a(49)(B) (Supp. V 2011); 15 U.S.C. § 78c(a)(71)(B) (Supp. V 2011).

with such swap (or security-based swap).[294] An entity may make an application with the CFTC or the Commission in order to limit the designation of "dealer" to certain categories of swaps or security-based swaps, as applicable.[295] Applications will be considered on an individual basis, but will invariably consider whether the applicant otherwise meets the "dealer" requirements discussed above.[296]

#### b. *Definition of Major Swap Participant or Major Security-Based Swap Participant*

Title VII of the Dodd-Frank Act requires that the CFTC and the Commission regulate "major swap participants" and "major security-based swap participants" respectively[297]—definitions that capture those entities that are not swap dealers or security-based swap dealers but that hold significant swap and/or security-based swap positions that create an especially high level of risk that could significantly impact the U.S. financial system.[298]

A "major swap participant" ("major security-based swap participant") is defined as an entity that is not a swap dealer (security-based swap dealer) and that fits into one of the following categories:

- Maintains a "substantial position" in swaps (security-based swaps) for any of the major swap categories, excluding positions held for "hedging or mitigating commercial risk" and positions maintained by any ERISA plan for the primary purpose of hedging or mitigating any risk associated with the operation of such plan;[299]
- Has outstanding swaps (security-based swaps) that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets;[300] or
- Is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency, and maintains a "substantial position" in outstanding swaps (security-based swaps) in any major category.[301]

In addition, the "major swap participant" definition excludes "an entity whose primary business is providing financing, and uses derivatives for the purposes

294. Further Definitions, *supra* note 272, 77 Fed. Reg. at 30744, 30755 (to be codified at 17 C.F.R. §§ 1.3(ggg)(3), 240.3a71-1(c)).

295. *Id.* at 30744, 30755 (to be codified at 17 C.F.R. §§ 1.3(ggg)(3), 240.3a71-1(c)).

296. *Id.* at 30645.

297. *See, e.g.*, Dodd-Frank Act § 712, 15 U.S.C. § 8302 (Supp. V 2011).

298. 7 U.S.C. § 1a(33)(A)(ii) (Supp. V 2011); 15 U.S.C. § 78c(a)(67)(A)(ii)(II) (Supp. V 2011).

299. 7 U.S.C. § 1a(33)(A)(i)(I)–(II) (Supp. V 2011); 15 U.S.C. § 78c(a)(67)(A)(ii)(I) (Supp. V 2011).

300. 7 U.S.C. § 1a(33)(A)(ii) (Supp. V 2011); 15 U.S.C. § 78c(a)(67)(A)(ii)(II) (Supp. V 2011).

301. 7 U.S.C. § 1a(33)(A)(iii)(I)–(II) (Supp. V 2011); 15 U.S.C. § 78c(a)(67)(A)(ii)(III)(aa)–(bb) (Supp. V 2011).

of hedging underlying commercial risks related to interest rate and foreign currency exposures, ninety percent or more of which arise from financing that facilitates the purchase or lease of products, ninety percent or more of which are manufactured by the parent company or another subsidiary of the parent company."[302] The "major security-based swap participant" definition does not contain this exclusion.

#### (i) Major Categories of Swaps or Security-Based Swaps

The rules promulgated under the CEA identify four "major" categories of swaps: rate swaps, credit swaps, equity swaps, and other commodity swaps.[303] The two "major" categories of security-based swaps are debt security-based swaps and other security-based swaps.[304]

#### (ii) Substantial Position

The CFTC and the Commission have defined "substantial position" to refer to swap positions that equal or exceed the specified threshold amounts in any of the major categories and which threshold amounts may be met under either of two tests.[305] The first substantial position test is determined by daily average aggregate uncollateralized outward exposure, with a threshold of $1 billion for each major category, except the major category of rate swaps for which the threshold is $3 billion.[306] One calculates aggregate uncollateralized outward exposure using mark-to-market accounting; the rules allow for the deduction of the value of collateral posted with respect to swap positions, as well as measuring exposure in any major category on a net basis according to the terms of any applicable master netting agreement with a particular counterparty.[307] The second test measures daily average aggregate of uncollateralized outward exposure plus daily average aggregate potential outward exposure, with a threshold of $2 billion for each major category, except the major category of rate swaps where the threshold is $6 billion.[308] The second test determines aggregate potential outward exposure by multiplying the total notional principal amount of swap positions by a specified risk factor amount determined by the type of swap and duration of the position—discounting the amount of positions subject to master netting agreements—and further discounting the amount of the position by 90 percent if the swaps are cleared, and 80 percent if the swaps are subject to daily mark-to-market margining.[309]

302. 7 U.S.C. § 1a(33)(D) (Supp. V 2011).
303. Further Definitions, *supra* note 272, 77 Fed. Reg. at 30748 (to be codified at 17 C.F.R. § 1.3(hhh)(7)(iii)(1)–(4)).
304. *Id.* at 30751 (to be codified at 17 C.F.R. § 240.3a67-2(a)–(b)).
305. *Id.* at 30748, 30751 (to be codified at 17 C.F.R. §§ 1.3(jjj), 240.3a67-3).
306. *Id.* at 30748, 30751 (to be codified at 17 C.F.R. §§ 1.3(jjj)(1), 240.3a67-3(a)).
307. *Id.* at 30748, 30751 (to be codified at 17 C.F.R. §§ 1.3(jjj)(2), 240.3a67-3(b)).
308. *Id.* at 30748, 30751 (to be codified at 17 C.F.R. §§ 1.3(jjj)(1), 240.3a67-3(a)).
309. *Id.* at 30748–49, 30752–53 (to be codified at 17 C.F.R. §§ 1.3(jjj)(3), 240.3a67-3(c)).

#### (iii) Hedging or Mitigating Commercial Risk

The definition of substantial position excludes positions maintained for "hedging or mitigating commercial risk."[310] The rules define the phrase "hedging or mitigating commercial risk" to include any swap position that:

- Qualifies as bona fide hedging under CEA rules;
- Qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codifications Topic 815, Derivatives and Hedging (formerly known as Statement No. 133) or Governmental Accounting Standards Board Statement 53, Accounting and Financial Reporting for Derivative Instruments;
- Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where risks arise in the ordinary course of business from:
  - Potential changes in the value of a person's (i) assets, (ii) liabilities, or (iii) services;
  - Potential changes in value related to any of the foregoing arising from foreign exchange rate movements; or
  - A fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's assets or liabilities.[311]

The definition specifically excludes any swap position held for a purpose that is in the nature of speculation, investing, or trading.[312]

#### (iv) Substantial Counterparty Exposure

Substantial counterparty exposure is measured against specified thresholds. The threshold for uncollateralized exposure is $5 billion, or a sum of current uncollateralized exposure and potential outward exposure of $8 billion.[313] All swaps are used in calculating the threshold amounts, by contrast to the calculation of substantial position that is calculated separately for each major category of swaps or security-based swaps, as applicable, and excludes swaps or security-based swaps, as applicable, entered into to hedge or mitigate commercial risk and positions maintained for ERISA plans.[314]

#### (v) Financial Entity and Highly Leveraged

For purposes of defining major swap participant and major security-based swap participant, the CFTC and the Commission refined the meaning of "financial entity"—which term is also used in an exception to mandatory clearing—to

310. *See id*. at 30746, 30751 (to be codified at 17 C.F.R. §§ 1.3(hhh)(1)(ii)(A), 240.3a67-1(a)(2)(i)).
311. *Id*. at 30750, 30753 (to be codified at 17 C.F.R. §§ 1.3(kkk)(1)(i)–(iii), 240.3a67-4(a)).
312. *Id*. at 30750, 30754 (to be codified at 17 C.F.R. §§ 1.3(kkk)(2)(i), 240.3a67-4(b)(1)).
313. *Id*. at 30750 (to be codified at 17 C.F.R. § 1.3(*lll*)(1)); *compare id*. at 30754 (to be codified at 17 C.F.R. § 240.3a67-5(a) (setting analogous thresholds at $2 billion and $4 billion for major security-based swap participants)).
314. *Id*. at 30750, 30754 (to be codified at 17 C.F.R. §§ 1.3(*lll*)(2), 240.3a67-5(b)).

exclude certain swap and security-based swap positions of centralized hedging and treasury entities within a corporate group.[315] An entity will not fall within either of these definitions solely because it facilitates hedging activities involving swaps or security-based swaps by majority-owned affiliates that themselves are not financial entities.[316]

The rules define the term "highly leveraged" to mean a ratio of an entity's total liabilities to equity in excess of twelve to one.[317] This ratio is calculated on a quarterly basis for purposes of determining an entity's status as a major swap participant or major security-based swap participant.[318]

*c. Eligible Contract Participant*

The Dodd-Frank Act created a new section 2(e) of the CEA that prohibits an entity that is not an eligible contract participant ("ECP") from entering into a swap except on, or subject to the rules of, a designated contract market.[319] In 2012, the CFTC and the Commission expanded upon the congressional definition of ECP so that major swap participants, swap dealers, major security-based swap participants, and security-based swap dealers are now ECPs.[320]

Title VII of the Dodd-Frank Act also amended the ECP definition by providing that certain commodity pools that engage in retail foreign exchange ("Forex") transactions face derivatives eligibility restrictions.[321] A Forex commodity pool that directly enters into a retail Forex transaction is no longer permitted to qualify as an ECP under clause (A)(iv) or clause (A)(v) of the ECP definition if the pool has one or more direct participants that are not themselves ECPs.[322] Other rules regarding ECPs provide as follows:

- In determining whether a commodity pool that is a direct participant in a transaction-level Forex pool is an ECP, the indirect participants in the transaction-level Forex pool will not be considered unless the pertinent entities were structured to evade regulation; that is, the "indefinite look-through" of the proposed rule was changed to an "evasion-based look-through" in the final rule.[323]
- An enforcement action would not be expected if one has reasonable policies to verify ECP status of Forex pool counterparties and, despite

315. *Id.* at 30685 (to be codified at 17 C.F.R. §§ 1.3(mmm)(1), 240.3a67-6(a)); *compare* Dodd-Frank Act §§ 723, 763, 7 U.S.C. § 2(h)(7)(c) (Supp. V 2011) (defining "financial entity"), 15 U.S.C. § 78c-3(g)(3) (Supp. V 2011) (same).

316. Further Definitions, *supra* note 272, 77 Fed. Reg. at 30750, 30754 (to be codified at 17 C.F.R. §§ 1.3(mmm)(1), 240.3a67-6(b)).

317. *Id.* at 30751, 30754 (to be codified at 17 C.F.R. §§ 1.3(mmm)(2), 240.3a67-7).

318. *Id.*

319. Dodd-Frank Act § 723(a)(2), 7 U.S.C. § 2(e) (Supp. V 2011).

320. Further Definitions, *supra* note 272, 77 Fed. Reg. at 30743–44 (to be codified at 17 C.F.R. § 1.3(m)(1)–(4)); *see also* 7 U.S.C. § 1a(18) (Supp. V 2011).

321. *See* Dodd-Frank Act § 741(b)(10), 7 U.S.C. § 1a(18)(A)(iv)(II) (Supp. V 2011).

322. Further Definitions, *supra* note 272, 77 Fed. Reg. at 30650 (to be codified at 17 C.F.R. § 1.3(m)(5)(i)).

323. *Id.* (to be codified at 17 C.F.R. § 1.3(m)(5)(ii)).

following those policies, one enters into retail Forex transactions with such a Forex pool in good faith and it is subsequently determined that U.S. participants represented no more than a de minimis number of participants or amount of ownership of the Forex pool.[324] For the purposes of 7 U.S.C. § 1a(18)(A)(iv) and 17 C.F.R. § 1.3(m)(5), the CFTC and the Commission will permit commodity pool operators ("CPO") and retail Forex transaction counterparties to rely reasonably in good faith on written representations that the pool participants are themselves ECPs.[325]

- A commodity pool will be considered an ECP if it has total assets exceeding $5 million and is operated by a registered or exempt CPO.[326]
- An entity that hedges or mitigates commercial risk may qualify as an ECP if all of its owners are ECPs and any one of the owners has a net worth exceeding $1 million.[327]
- Certain Forex commodity pools that enter into retail Forex transactions qualify as ECPs, irrespective of whether each participant in the pool is an ECP, if the pool:
  - Is not formed for the purpose of evading CFTC regulations;
  - Has total assets exceeding $10 million; and
  - Is formed and operated by a registered or exempt CPO.[328]

*d. Revisions to Government Entity ECP Status*

Title VII of the Dodd-Frank Act raised the monetary threshold that government entities may use to qualify as ECPs in certain situations from $25 million to $50 million in investments owned and invested on a discretionary basis.[329] In defining ECP to include certain government entities, Congress erroneously cross-referenced another statutory provision, so the Commission and the CFTC intend to issue interpretive guidance to effectuate congressional intent.[330]

### 6. Product Definitions

As required by section 721(d) of the Dodd-Frank Act,[331] the CFTC and the Commission adopted rules further defining the terms "swap," "security-based

324. *Id.* at 30652 (to be codified at 17 C.F.R. § 1.3(m)(5)).
325. *Id.* (to be codified at 17 C.F.R. § 1.3(m)(5)).
326. *Id.* at 30655 (to be codified at 17 C.F.R. § 1.3(m)(6)).
327. *Id.* at 30657 (to be codified at 17 C.F.R. § 1.3(m)(7)).
328. *Id.* at 30659 (to be codified at 17 C.F.R. § 1.3(m)(8)).
329. Dodd-Frank Act § 721(a)(9), 7 U.S.C. § 1a(10)(A)(vii) (Supp. V 2011).
330. Further Definitions, *supra* note 272, 77 Fed. Reg. at 30655–56 (suggesting that the cross-reference should have been to 7 U.S.C. § 2(c)(2)(B)(i)(II)(aa)–(ff), rather than 7 U.S.C. § 2(c)(2)(B)(ii)(I)–(VI), which would render the cross-reference a nullity).
331. Dodd-Frank Act § 721(d)(1), 124 Stat. at 1644 (codified in scattered sections of the U.S.C.).

swap," and "security-based swap agreement" on July 18, 2012.[332] The CFTC retains jurisdiction over swaps, the SEC retains jurisdiction over security-based swaps, and the agencies share jurisdiction over mixed swaps.[333] Given that Title VII defines "swaps" broadly, the agencies adopted a number of exclusions from the swap and security-based swap definitions in order to provide greater certainty for market participants.

Section 721 of the Dodd-Frank Act defines the terms "swap" and "mixed swap,"[334] and section 761 of the Dodd-Frank Act defines a "security-based swap."[335] The term "swap" is broadly defined to include many types of derivatives across asset classes, but excludes, among other things, nonfinancial or security forwards that are intended to be physically settled, futures contracts, listed foreign exchange options, debt securities, securities options, and forward contracts that are subject to the Securities Act and the Exchange Act, security-based swaps.[336] A "security-based swap" is defined to include a swap based on a single security or loan or narrow-based security index.[337] The definition also includes credit default swaps relating to a single issuer or the issuers in a narrow-based security index.[338]

Given the breadth of the definitions of "swap" and "security-based swap," the CFTC and the Commission lessened the risk of those terms being construed overinclusively by adopting safe harbors for various types of agreements or instruments that will not be considered "swaps" or "security-based swaps."[339]

For example, the rules provide that certain consumer transactions—including transactions entered into primarily for personal, family, or household purposes, such as real estate transactions, mortgages, personal service contracts, and related rate locks and caps—are excluded from the definitions of swap and security-based swap.[340] Likewise, commercial transactions, including employment, sales, and servicing arrangements, business combinations, inventory and IP transfers, and other similar financial arrangements, are excluded from those definitions.[341]

The rules provide a safe harbor for insurance contracts that satisfy specified criteria. For example, the rules provide a safe harbor for a long list of insurance products, including life insurance, health insurance, long-term care insurance, and disability insurance.[342] The safe harbor also generally requires that (a) the

332. Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208 (Aug. 13, 2012) (to be codified at 17 C.F.R. pts. 230, 240 & 241) [hereinafter Product Definitions]. Publication of those rules in the Federal Register on August 13, 2012, triggered a cavalcade of compliance dates for various Title VII requirements.

333. Dodd-Frank Act § 712(a)(8), (b)(1)–(2), 15 U.S.C. § 8302(a)(8), (b)(1)–(2) (Supp. V 2011).

334. *Id.* § 721, 7 U.S.C. § 1a(47) (Supp. V 2011).

335. *Id.* § 761, 15 U.S.C. § 78c(a)(68) (Supp. V 2011).

336. 7 U.S.C. § 1a(47) (Supp. V 2011).

337. 15 U.S.C. § 78c(a)(68) (Supp. V 2011).

338. *See id.*

339. Product Definitions, *supra* note 332, 77 Fed. Reg. at 48211.

340. *Id.* at 48246.

341. *Id.* at 48247.

342. *Id.* at 48350, 48361 (to be codified at 17 C.F.R. §§ 1.3(xxx)(4)(i)(C), 240.3a69-1(a)(3)).

insurance provider is regulated,[343] (b) the insurance provider bears the risk of loss,[344] and (c) the insurance contract is not traded separately from the insured interest in an organized market or over the counter.[345]

Certain loan participations are outside of the scope of the definitions provided that they satisfy certain criteria enumerated in the final release.[346]

The adopting release confirms that the CFTC and the Commission will continue to apply longstanding guidance in considering forward contracts and provides clarifications regarding book-outs and contracts with embedded optionality.[347]

The agencies also provide extensive guidance regarding the characteristics of an "index" for purposes of ascertaining whether a product referencing an index should be characterized as a swap (if the product references a broad-based index), or a security-based swap (if it references a narrow-based index), or a mixed swap (if it references a migrating index).[348]

The rules also provide for a process whereby market participants may seek joint interpretations from the agencies regarding the status of any new instrument as a swap, security-based swap, or mixed swap.[349]

### 7. Process for Security-Based Swap Clearing Submissions

The Dodd-Frank Act created a new section 3C of the Exchange Act that establishes clearing requirements with respect to security-based swaps.[350] Section 3C provides that "[i]t shall be unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to a clearing agency that is registered under this Act or a clearing agency that is exempt from registration under this Act if the security-based swap is required to be cleared."[351] Rule 19b-4, Form 19b-4, and section 3C(a)(1) of the Exchange Act provide the framework for submitting a security-based swap for clearing.[352]

In addition, section 806(e) of the Dodd-Frank Act requires any financial market utility designated as systemically important to file notice sixty days in advance of changes to any of its rules, procedures, or operations that could materially affect the nature or level of risk presented by the financial market utility.[353]

343. *Id.* at 48350, 48361 (to be codified at 17 C.F.R. §§ 1.3(xxx)(4)(i)(B), 240.3a69-1(a)(2)).
344. *Id.* at 48350, 48361 (to be codified at 17 C.F.R. §§ 1.3(xxx)(4)(i)(A), 240.3a69-1(a)(1)).
345. *Id.*
346. *Id.* at 48250–51.
347. *Id.* at 48228–30, 48237, 48254–260.
348. *Id.* at 48271–89, 48351, 48358 (to be codified at 17 C.F.R. §§ 1.3(yyy), 240.3a68-1b).
349. *Id.* at 48354, 48359 (to be codified at 17 C.F.R. §§ 1.8, 240.3a68-2).
350. Dodd-Frank Act § 763(a), 15 U.S.C. § 78c-3 (Supp. V 2011).
351. 15 U.S.C. § 78c-3(a)(1) (Supp. V 2011).
352. *Id.*; Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41602 (July 13, 2012) (to be codified at 17 C.F.R. §§ 240.19b-4, 249.819) [hereinafter Process for Submissions]. The text of Form 19b-4 will not appear in the Code of Federal Regulations. *Id.* at 41650.
353. Dodd-Frank Act § 806(e)(1)(A), 12 U.S.C. § 5465(e)(1)(A) (Supp. V 2011).

Rule 19b-4(o) provides the framework by which clearing agencies shall make such advance notice requirements.[354]

*a. Process for Making Security-Based Swap Submissions to the Commission*

Section 3C of the Exchange Act requires each clearing agency that plans to accept a security-based swap to file a submission with the Commission to determine whether the security-based swap (or any group, category, type, or class of security-based swaps) referenced in the submission is required to be cleared.[355] Clearing agencies submit security-based swaps to the Commission for review by group, category, type, or class to the extent that doing so is practicable and reasonable.[356] A clearing agency must submit the requisite information electronically on Form 19b-4.[357]

The substance of the submission must include a statement explaining how the submission is consistent with section 17A of the Exchange Act.[358] Section 17A of the Exchange Act specifies that, with regard to the registration of a clearing agency, the Commission have due regard for the public interest, investor protection, safeguarding of securities and funds, maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents, and facilitation of a national system that promptly and accurately clears and settles transactions.[359] A registered clearing agency also is required under section 17A of the Exchange Act to provide fair access to clearing and to have the capacity to facilitate the prompt and accurate clearance and settlement of securities and derivative transactions for which it is responsible.[360] The Commission suggested that it will review the substance of the submission in a manner that is similar to its review of submissions for proposed rule changes under section 19(b) of the Exchange Act.[361]

Paralleling the factors set forth in section 3C of the Exchange Act,[362] the Commission requires the submission of information that will assist its qualitative and quantitative assessment of the following factors:

(i) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data;

(ii) The availability of a rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on

354. Process for Submissions, *supra* note 352, 77 Fed. Reg. at 41649 (to be codified at 17 C.F.R. § 240.19b-4(o)).

355. 15 U.S.C. § 78c-3(b)(2) (Supp. V 2011).

356. Process for Submissions, *supra* note 352, 77 Fed. Reg. at 41649–50 (to be codified at 17 C.F.R. § 240.19b-4(o)(1), (4)).

357. *Id.* at 41649 (to be codified at 17 C.F.R. § 240.19b-4(o)(2)).

358. *Id.* (to be codified at 17 C.F.R. § 240.19b-4(o)(3)(i)).

359. 15 U.S.C. § 78q-1(b)(3)(F) (Supp. V 2011).

360. *Id.* § 78q-1(b)(3)(A), (B), (F).

361. *See* Process for Submissions, *supra* note 352, 77 Fed. Reg. at 41607 ("The Commission generally believes that when a security-based swap is submitted for review under Exchange Act Section 3C and concurrently filed under Exchange Act Section 19(b) as a proposed rule change, the two separate reviews will be carried out on the same general timeline and likely involving the same staff . . . .").

362. 15 U.S.C. § 78c-3(b)(4)(B)(i)–(v) (2006).

terms that are consistent with the material terms and trading conventions on which the contract is then traded;

(iii) The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the clearing agency available to clear the contract;

(iv) The effect on competition, including appropriate fees and charges applied to clearing; and

(v) The existence of reasonable legal certainty in the event of the insolvency of the relevant clearing agency or one or more of its clearing members with regard to the treatment of customer and security-based swap counterparty positions, funds, and property.[363]

In making its determination of whether the clearing requirement applies, the Commission can require the production of additional information from clearing agencies.[364]

*b. Substance of Security-Based Swap Submissions: Open Access*

Section 3C of the Exchange Act mandates that the rules of a clearing agency provide for open access if that agency clears security-based swaps subject to the clearing requirement.[365] In the course of reviewing a submission by a clearing agency concerning a security-based swap, the Commission may assess whether a clearing agency's rules provide for open access.[366] Under the Commission's rules, a clearing agency's submission must include a statement describing how its rules:

(i) Prescribe that all security-based swaps submitted to the clearing agency with the same terms and conditions are economically equivalent within the clearing agency and may be offset with each other within the clearing agency; and

(ii) Provide for non-discriminatory clearing of a security-based swap executed bilaterally or on or through the rules of an unaffiliated national securities exchange or security-based swap execution facility.[367]

*c. Publication, Posting, and Notice Requirements*

Both clearing agencies and the Commission have publication, posting, and notice requirements.[368] Clearing agencies are required to provide contemporaneously to the Federal Reserve Board and to the Commission copies of all materials

363. Process for Submissions, *supra* note 352, 77 Fed. Reg. at 41649–50 (to be codified at 17 C.F.R. § 240.19b-4(o)(3)(ii)(A)–(E)).
364. *Id.* at 41650 (to be codified at 17 C.F.R. § 240.19b-4(o)(6)).
365. 15 U.S.C. § 78c-3(a)(2) (Supp. V 2011).
366. Process for Submissions, *supra* note 352, 77 Fed. Reg. at 41612.
367. *Id.* at 61650 (to be codified at 17 C.F.R. § 240.19b-4(o)(3)(iii)–(iv)).
368. *Id.* at 41649 (to be codified at 17 C.F.R. § 240.19b-4(n)).

relating to an advance notice submission.[369] In addition, a clearing agency is required to provide the Commission with advance notice of any proposed rule change that could materially affect the nature or level of risks presented by that clearing agency.[370]

The Commission is required to make the filing and substance of each submission it receives publicly available in the Federal Register.[371] The Commission is required to "provide at least a 30-day public comment period regarding its determination whether the clearing requirement . . . shall apply to the submission."[372]

Clearing agencies are required to post certain information on their websites, unless confidential treatment is requested by the clearing agency.[373] This information, including the timeline for posting, is as follows:

- All submissions, including advance notices and amendments within two business days of filing the notice or amendment.[374] This information may be removed from the website upon either withdrawal or effectiveness of the advance notice.[375]
- A proposed change to an advance notice within two days of the date it has been permitted to take effect.[376]
- Effective date of the change if different than the date the change is permitted to take effect.[377]

Self-regulatory organizations ("SROs") have separate notice requirements. Whereas the Commission must "prompt[ly]" publish to the Federal Register any notice of a proposed rule change by a clearing agency,[378] the Commission is required to send notice of a proposed rule change filed by an SRO to the Federal Register within fifteen days of the SRO publishing the proposed rule change to its website.[379] To comply with the statute, the Commission now requires an SRO to inform the Commission of the date it will post the proposal to its website if it is different than the date on which the proposal is filed with the Commission.[380]

369. *Id.* (to be codified at 17 C.F.R. § 240.19b-4(n)(5)).
370. *Id.* (to be codified at 17 C.F.R. § 240.19b-4(n)(1)–(2)).
371. *Id.* at 41622 (to be codified at 17 C.F.R. § 240.19b-4(n)(1)).
372. 15 U.S.C. § 78c-3(b)(2)(C)(iii) (Supp. V 2011).
373. Process for Submissions, *supra* note 352, 77 Fed. Reg. at 41649 (to be codified at 17 C.F.R. §§ 240.19b-4(n)(3)–(4) (requiring posting to website), 240.19b-4(n)(6) (not requiring posting to website when confidential treatment properly requested)).
374. *Id.* at 41649–50 (to be codified at 17 C.F.R. § 240.19b-4(n)(3)–(4), (o)(5)).
375. *Id.* at 41649–50 (to be codified at 17 C.F.R. § 240.19b-4(n)(3), (o)(5)).
376. *Id.* at 41649 (to be codified at 17 C.F.R. § 240.19b-4(n)(4)(i)).
377. *Id.* (to be codified at 17 C.F.R. § 240.19b-4(n)(4)(ii)).
378. *Id.* (to be codified at 17 C.F.R. § 240.19b-4(n)(1)(i)).
379. *See* 15 U.S.C. § 78s(b)(2)(E) (Supp. V 2011).
380. Process for Submissions, *supra* note 352, 77 Fed. Reg. at 41648–49 (to be codified at 17 C.F.R. § 240.19b-4(*l*)).

*d. Stay of the Clearing Requirement and Review by the Commission*

Rule 3Ca-1 permits a stay of the mandatory clearing requirement.[381] A counterparty to a security-based swap requesting a stay is required to submit a written statement to the Commission that includes (i) a request for a stay of the clearing requirement, (ii) the identity of the counterparties to the security-based swap and a contact at the counterparty requesting the stay, (iii) the identity of the clearing agency clearing the security-based swap, (iv) the terms of the security-based swap subject to the clearing requirement and a description of the clearing arrangement, and (v) the reasons a stay should be granted and the security-based swap should not be subject to a clearing requirement, specifically addressing the same factors a clearing agency must address in its security-based swap submission.[382] Any clearing agency that is subject to a stay in respect of a security-based swap will be required to provide further information as requested by the Commission during the course of its review.[383]

*e. Notice Filing Requirements for Designated Clearing Agencies*

The Commission amended Rule 19b-4 to add a new section (n) for purposes of advance notices.[384] Section 806(e) of the Dodd-Frank Act requires any financial market utility designated by the Financial Stability Oversight Council as systemically important to file sixty days' advance notice of changes to its rules, procedures, or operations that could "materially affect the nature or level of risk presented by the designated financial market utility."[385] These notices are required to be filed electronically on Form 19b-4.[386]

The phrase "materially affect the nature or level of risks presented" is defined to mean the existence of a "reasonable possibility that the change could affect the performance of essential clearing and settlement functions or the overall nature or level of risk presented by the designated clearing agency."[387]

The Commission set forth two broad categories of changes to rules, procedures, or operations that would not materially affect the nature or level of risks presented by a designated clearing agency and, therefore, would not require the filing of an advance notice:

(i) Changes to an existing procedure, control, or service that do not modify the rights or obligations of the designated clearing agency or persons using its payment, clearing, or settlement services and that do not adversely affect the safeguarding of securities, collateral, or funds in the

381. *Id.* at 41648 (to be codified at 17 C.F.R. § 240.3Ca-1).
382. *Id.* (to be codified at 17 C.F.R. § 240.3Ca-1(b)(1)–(5)).
383. *Id.* (to be codified at 17 C.F.R. § 240.3Ca-1(d)).
384. *Id.* at 41649 (to be codified at 17 C.F.R. § 240.19b-4(n)).
385. Dodd-Frank Act § 806(e)(1)(A), 12 U.S.C. § 5465(e)(1)(A) (Supp. V 2011).
386. Process for Submissions, *supra* note 352, 77 Fed. Reg. at 41624, 41651 (reflecting revised Form 19b-4).
387. *Id.* at 41649 (to be codified at 17 C.F.R. § 240.19b-4(n)(2)(i)).

custody or control of the designated clearing agency or for which it is responsible; or

(ii) Changes concerned solely with the administration of the designated clearing agency or related to the routine, daily administration, direction, and control of employees.[388]

The Commission also set forth a non-exhaustive list of changes that could be considered "material," including changes that materially affect participant and product eligibility, risk management, daily or intraday settlement procedures, default procedures, system safeguards, governance, or financial resources of the designated clearing agency.[389]

*f. Timeline for Approval Process*

The timeline for the approval process is set forth by the Dodd-Frank Act.[390] The Commission must object to a proposal within sixty days of (i) the receipt of an advance notice or (ii) the receipt of additional information that had been requested regarding an advance notice.[391] The review period may be extended for an additional sixty days if the Commission finds that the proposal raises novel or complex issues.[392] A proposal may be implemented if no objection has been received during the review period.[393] Section 806(e)(4) requires that the Commission consult with the Federal Reserve Board before taking any action on, or completing its review of, the change referred to in the advance notice.[394] Upon completion of its review, the Commission may determine that (i) the security-based swap must be cleared, either unconditionally or subject to specified conditions,[395] or (ii) the mandatory clearing requirement does not apply to a security-based swap (or group, category, type, or class of security-based swaps).[396]

*g. Effective and Compliance Dates*

Both the effective and compliance dates for Rule 3Ca-1, Rule 3Ca-2, and the amendments to Rules 19b-4 was August 13, 2012, with one exception.[397] The compliance date for Rule 19b-4(o) will be the date that is sixty days after the date the Commission issues its first written determination of whether a security-based swap, or group, category, type, or class of security-based swaps, is required to be cleared.[398]

388. *Id.* (to be codified at 17 C.F.R. § 240.19b-4(n)(2)(iii)(A)–(B)).
389. *Id.* (to be codified at 17 C.F.R. § 240.19b-4(n)(2)(ii)).
390. Dodd-Frank Act § 806(e), 12 U.S.C. § 5465(e) (Supp. V 2011).
391. *Id.* § 806(e)(1)(E)(i)–(ii), 12 U.S.C. § 5465(e)(1)(E)(i)–(ii) (Supp. V 2011).
392. *Id.* § 806(e)(1)(H), 12 U.S.C. § 5465(e)(1)(H) (Supp. V 2011).
393. *See id.* 806(e)(1)(F)–(G), 12 U.S.C. § 5465(e)(1)(F)–(G) (Supp. V 2011).
394. *Id.* § 806(e)(4), 12 U.S.C. § 5465(e)(4) (Supp. V 2011).
395. Process for Submissions, *supra* note 352, 77 Fed. Reg. at 41648 (to be codified at 17 C.F.R. § 240.3Ca-1(e)(1)).
396. *Id.* (to be codified at 17 C.F.R. § 240.3Ca-1(e)(2)).
397. *Id.* at 41602.
398. *Id.* at 41626.

## II. JOBS Act Related Rulemaking

### A. General

The JOBS Act[399] affects both exempt and registered offerings, as well as the reporting requirements for certain public issuers, and is intended to promote capital formation. A number of provisions of the JOBS Act were effective upon enactment; however, other provisions require that the Commission or other agencies conduct studies or that the Commission undertake rulemaking to implement the provisions of the Act.

Title I of the JOBS Act addresses concerns that regulatory burdens deterred growing companies from pursuing initial public offerings, or IPOs, in the United States by modernizing the IPO process to make it more accessible.[400] Title II of the JOBS Act directs the Commission to amend its rules to eliminate the ban on general solicitation and general advertising for certain Rule 506 offerings when actual sales are made only to verified accredited investors, and to make comparable changes to Rule 144A.[401] Title II also permits internet "matchmaking sites" to facilitate offerings under Rule 506 without the need to register as broker-dealers, provided that the sites limit their services as specified in the JOBS Act.[402] Title III establishes a small offering exemption for crowdfunding and requires that the Commission undertake rulemaking to create a framework for these offerings.[403] Title IV of the JOBS Act creates a new exemption under section 3(b)(2), similar to current Regulation A, for offerings of up to $50 million.[404] Title IV also requires that the Commission undertake rulemaking.[405] Titles V and VI raise the holder-of-record threshold for mandatory registration under the Exchange Act.[406]

Title I of the JOBS Act, which was made retroactively effective to December 9, 2011, for qualifying issuers,[407] contains provisions that address registered public offerings by a new class of issuer, "emerging growth companies" (EGCs),[408] and the communications framework applicable to them.[409] These "IPO on-ramp" provisions streamline the IPO registration process for EGCs by lessening certain disclosure requirements[410] and permitting EGCs to submit their IPO registration statements for confidential review by the Commission.[411] In addition, EGCs are subject to certain of the more onerous corporate governance requirements

399. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.) [hereinafter JOBS Act].

400. *Id.* §§ 101–108, 126 Stat. at 307–13 (to be codified in scattered sections of 15 U.S.C.).

401. *Id.* § 201, 126 Stat. at 313 (to be codified at 15 U.S.C. § 77d).

402. *Id.* § 201(b), 126 Stat. at 314 (to be codified at 15 U.S.C. § 77d).

403. *Id.* §§ 301–305, 126 Stat. at 315–23 (to be codified in scattered sections of 15 U.S.C.).

404. *Id.* § 401, 126 Stat. at 323 (to be codified at 15 U.S.C. §§ 77c, 77d, 77r).

405. *Id.* § 401(a)(2), 126 Stat. at 324 (to be codified at 15 U.S.C. § 77c(b)(2)).

406. *Id.* §§ 501–504, 601–602, 126 Stat. at 325–27 (to be codified at 15 U.S.C. §§ 78*l*(g), 78o(d)).

407. *Id.* § 101(d), 126 Stat. at 308 (to be codified at 15 U.S.C. § 77b note).

408. *Id.* § 101(a), 126 Stat. at 307 (to be codified at 15 U.S.C. § 78c(a)(80)).

409. *Id.* § 105, 126 Stat. at 310 (to be codified in scattered sections of 15 U.S.C.).

410. *Id.* § 102, 126 Stat. at 308 (to be codified in scattered sections of 15 U.S.C.).

411. *Id.* § 106(a), 126 Stat. at 312 (to be codified at 15 U.S.C. § 77f(e)).

only after the passage of time,[412] and they enjoy greater freedom when communicating with potential institutional investors prior to and during offerings through test-the-waters discussions.[413] To promote market interest in EGCs, Title I also relaxes certain of the prohibitions relating to the publication of research reports relating to EGCs.[414]

An EGC is defined as an issuer (including a foreign private issuer) with total annual gross revenues of less than $1 billion (subject to inflationary adjustment by the Commission every five years) during its most recently completed fiscal year.[415] An issuer can qualify as an EGC if it first sold its common stock in a registered offering on or after December 9, 2011.[416] Status as an EGC is maintained until the earliest of:

- the last day of the fiscal year in which the issuer's total annual gross revenues are $1 billion or more;
- the last day of the issuer's fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act (so, for an issuer of debt that never sold its common equity pursuant to a Securities Act registration statement, the time limitation on EGC-status will not have commenced, under this criterion);
- any date on which the issuer has, during the prior three-year period, issued more than $1 billion in non-convertible debt; or
- the date on which the issuer becomes a "Large Accelerated Filer," as defined in the Commission's rules.[417]

Consequently, once an issuer loses its EGC status, it cannot be regained.

Title II of the JOBS Act, titled "Access to Capital for Job Creators," requires that the Commission undertake rulemaking to revise the prohibition against general solicitation.[418] Specifically, within ninety days following enactment of the Act, the Commission was mandated to revise Rule 506 to make the prohibition against general solicitation or general advertising contained in Rule 502 inapplicable in the context of Rule 506 offerings, provided that all purchasers in the offering are accredited investors.[419] Issuers must take "reasonable steps" to verify that investors are accredited investors.[420] It was anticipated that the Commission would provide guidance regarding the types of steps that would be considered

412. *Id.* §§ 103–104, 126 Stat. at 310 (to be codified at 15 U.S.C. §§ 7213(a)(3)(C), 7262(b)).
413. *Id.* § 105(c), 126 Stat. at 311 (to be codified at 15 U.S.C. § 77e(d)).
414. *Id.* § 105(a), 126 Stat. at 310 (to be codified at 15 U.S.C. § 77b(a)(3)).
415. *Id.* § 101(a), (b), 126 Stat. at 307 (to be codified at 15 U.S.C. §§ 77b(a)(19), 78c(a)(80)).
416. *Id.* § 101(d), 126 Stat. at 308 (to be codified at 15 U.S.C. § 77b note).
417. *Id.* § 101(a), (b), 126 Stat. at 307 (to be codified at 15 U.S.C. §§ 77b(a)(19)(A)–(D), 78c(a)(80)(A)–(D)).
418. *Id.* § 201, 126 Stat. at 313–15 (to be codified at 15 U.S.C. § 77d).
419. *Id.* § 201(a)(1), 126 Stat. at 313.
420. *Id.*

"reasonable."[421] Also within the same time period, the Commission must revise Rule 144A(d)(1) to permit the use of general solicitation or general advertising.[422] Conforming changes will be required to ensure that any offering made pursuant to Rule 506 that uses general advertising or general solicitation will not be deemed a "public offering."[423]

Title II of the JOBS Act also provides that certain platforms that facilitate private placements need not register as broker-dealers.[424] These platforms usually utilize the internet to facilitate the offer and sale of securities in Rule 506 transactions. The JOBS Act provision generally codifies prior Commission no-action letter guidance concerning such platforms.[425] In this regard, the Commission staff has historically considered whether a platform receives transaction-based or contingent compensation, provides advice, participates in negotiations, or handles customer funds and securities in determining if the platform must register as a broker-dealer.[426] The receipt of transaction-based compensation generally indicates broker-dealer activity that would trigger the requirement to register as a broker-dealer.[427] Consistent with this longstanding approach, the JOBS Act requires that a Rule 506 platform and its associated persons receive "no compensation in connection with the purchase or sale" of a security.[428] A platform may provide certain ancillary services, such as conducting diligence or providing standardized deal documents.[429] The platforms cannot hold customer funds or securities and none of its associated persons may be subject to statutory disqualification as defined in section 3(a)(39) of the Exchange Act.[430]

Title III of the JOBS Act amends section 4 of the Securities Act to add a new paragraph (6) that provides a crowdfunding exemption from registration under the Securities Act.[431] The provisions of the JOBS Act relating to crowdfunding are not effective and require that the Commission undertake rulemaking.[432] The offering exemption is subject to a number of limitations on the aggregate amount offered. The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the crowdfunding exemption during the twelve-month period preceding the date of the transaction, may not exceed $1 million.[433] The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the crowdfunding exemption during the twelve-month period preceding the date of the transaction, does not exceed: (1) the greater of $2,000 or 5 percent of the annual income or net worth of the investor, as applicable, if

421. *Id.*
422. *Id.* § 201(a)(2), 126 Stat. at 314.
423. *Id.* § 201(a)(1), 126 Stat. at 313.
424. *Id.* § 201(c), 126 Stat. at 314 (to be codified at 15 U.S.C. § 77d).
425. *Id.* (to be codified at 15 U.S.C. § 77d(b)(2)).
426. *See, e.g.*, S3 Matching Techs. LP, SEC No-Action Letter, 2012 WL 294810 (July 19, 2012).
427. *See* 15 U.S.C. §§ 78c(a)(4), 78o (2006).
428. JOBS Act § 201(c), 126 Stat. at 314 (to be codified at 15 U.S.C. § 77d(b)(2)(A)).
429. *Id.* (to be codified at 15 U.S.C. § 77d(b)(3)(B)).
430. *Id.* (to be codified at 15 U.S.C. § 77d(b)(2)(B)–(C)).
431. *Id.* § 302(a), 126 Stat. at 315 (to be codified at 15 U.S.C. § 77d(6)).
432. *Id.* § 302(c), 126 Stat. at 320 (to be codified at 15 U.S.C. § 77d note).
433. *Id.* § 302(a), 126 Stat. at 315 (to be codified at 15 U.S.C. § 77d(6)(A)).

either the annual income or the net worth of the investor is less than $100,000; or (2) 10 percent of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.[434] The transaction must be conducted through a broker or an entity known as a funding portal.[435] The financial intermediary (broker-dealer or funding portal) is required to act as a "gatekeeper" and undertake certain precautions deemed necessary for investor protection, such as providing investors with certain disclosures, conducting background checks on the issuer's principals, and ensuring that investor funds are returned if the target amount of the offering is not received.[436]

In addition, an issuer must meet specific conditions in order to rely on the exemption, including that an issuer file with the Commission and provide to investors and intermediaries information about the issuer (including financial statements, which would be reviewed or audited depending on the size of the target offering amount), its officers, directors, and greater than 20 percent shareholders, and risks relating to the issuer and the offering, as well specific offering information such as the use of proceeds for the offering, the target amount for the offering, the deadline to reach the target offering amount, and regular updates regarding progress in reaching the target.[437] The provision prohibits issuers from advertising the terms of the exempt offering, other than to provide notices directing investors to the funding portal or broker, and requires disclosure of amounts paid to compensate solicitors promoting the offering through the channels of the broker or funding portal.[438]

An issuer that relies on the exemption would be subject to certain ongoing reporting requirements. An issuer would need to file with the Commission and provide to investors, no less than annually, reports of the results of operations and financial statements, all as the Commission may determine is appropriate.[439] The Commission may also impose any other requirements that it determines appropriate.[440]

Securities sold on an exempt basis under the crowdfunding exemption would not be transferable by the purchaser for a one-year period beginning on the date of purchase, except in certain limited circumstances.[441] The crowdfunding exemption is not available to any issuer organized outside of the United States, any issuer subject to the reporting requirements of the Exchange Act, any investment company, or any other category of issuer identified by the Commission.[442] Congress directed the Commission to disqualify bad actors from utilizing the

434. *Id.* (to be codified at 15 U.S.C. § 77d(6)(B)(i)–(ii)).
435. *Id.* (to be codified at 15 U.S.C. § 77d(6)(C)).
436. *Id.* § 302(b), 126 Stat. at 315 (to be codified at 15 U.S.C. § 77d-1(a)).
437. *Id.* (to be codified at 15 U.S.C. § 77d-1(b)(1)).
438. *Id.* (to be codified at 15 U.S.C. § 77d-1(b)(2)–(3)).
439. *Id.* (to be codified at 15 U.S.C. § 77d-1(b)(4)).
440. *Id.* (to be codified at 15 U.S.C. § 77d-1(b)(5)).
441. *Id.* (to be codified at 15 U.S.C. § 77d-1(e)(1)).
442. *Id.* (to be codified at 15 U.S.C. § 77d-1(f)).

crowdfunding exemption in substantially the same way that bad actors are ineligible to utilize the exemption provided by Regulation A.[443]

The JOBS Act establishes a new offering exemption pursuant to new subparagraph (2) of Securities Act section 3(b).[444] The exemption is similar to current Regulation A, which permits private companies to conduct small public offerings without registration.[445] There is no deadline for the Commission to implement rulemaking related to this exemption.

Under the exemption, an issuer will be able to offer and sell up to $50 million in securities within a twelve-month period without registration as generally required under the Securities Act.[446] The issuer may offer equity securities, debt securities, and debt securities convertible or exchangeable for equity interests, including any guarantees of such securities.[447] The securities sold pursuant to the exemption can be offered and sold publicly and will not be deemed "restricted securities."[448] The issuer may solicit interest in the offering prior to filing any offering statement with the Commission, subject to any additional conditions or requirements that may be imposed by the Commission.[449] Section 18 of the Securities Act generally exempts "covered securities" from regulation by the states, and the JOBS Act expanded the definition of "covered securities" to include securities issued pursuant to section 3(b)(2) so long as: (i) the securities are offered or sold on a national securities exchange or (ii) the securities are offered or sold to a "qualified purchaser" as defined by the Commission.[450] The civil liability provision in section 12(a)(2) will apply to any person offering or selling such securities.[451]

The JOBS Act provides the Commission with authority to impose other terms, conditions, or requirements that it deems necessary for investor protection, including a requirement that the issuer prepare and file electronically with the Commission and distribute to prospective investors an offering statement and any related documents, including a description of the issuer's business and financial condition, its corporate governance principles, the intended uses of proceeds, and other appropriate matters.[452] The JOBS Act specifies that the Commission must require that the issuer file audited financial statements with the Commission annually,[453] and the Commission also may require an issuer relying on the exemption to make those statements available to investors and file periodic disclosures.[454] The bad actor disqualification provisions applicable for the

443. *Id.* § 302(d), 126 Stat. at 320 (to be codified at 15 U.S.C. § 77d note).
444. *Id.* § 401(a), 126 Stat. at 323 (to be codified at 15 U.S.C. § 77c(b)(2)).
445. *See* 17 C.F.R. §§ 230.251–230.263 (2012).
446. JOBS Act § 401(a), 126 Stat. at 323 (to be codified at 15 U.S.C. § 77c(b)(2)(A)).
447. *Id.* (to be codified at 15 U.S.C. § 77c(b)(3)).
448. *Id.* (to be codified at 15 U.S.C. § 77c(b)(2)(B)–(C)).
449. *Id.* (to be codified at 15 U.S.C. § 77c(b)(2)(E)).
450. *Id.* § 401(b), 126 Stat. at 325 (to be codified at 15 U.S.C. § 77r(b)(4)(D)(i)–(ii)).
451. *Id.* § 401(a), 126 Stat. at 323 (to be codified at 15 U.S.C. § 77c(b)(2)(D)).
452. *Id.* (to be codified at 15 U.S.C. § 77c(b)(2)(G)(i)).
453. *Id.* (to be codified at 15 U.S.C. § 77c(b)(2)(F)).
454. *Id.* (to be codified at 15 U.S.C. § 77c(b)(4)).

exemption must be substantially similar to the disqualification provisions contained in still-pending regulations pursuant to section 926 of the Dodd-Frank Act.[455]

Prior to the enactment of the JOBS Act, Exchange Act section 12(g), as implemented by the Commission, required registration of a class of an issuer's equity securities if, as of the last day of the issuer's fiscal year: (i) the issuer had more than $10 million in assets and (ii) the class of equity securities was held of record by 500 or more persons.[456] As amended by Titles V and VI of the JOBS Act, Exchange Act section 12(g) now requires registration if, at the end of its fiscal year, a company has at least $10 million in assets and a class of equity securities held of record by either (i) 2,000 persons or (ii) 500 persons who are not accredited investors.[457] Banks and bank holding companies are not required to register unless they have, at the end of the fiscal year, at least $10 million in assets and a class of equity securities held of record by 2,000 or more persons.[458] Prior to the enactment of the JOBS Act, under Exchange Act section 12(g)(4), as implemented by the Commission, an issuer could deregister a class of equity securities when either: (i) the issuer had $10 million or less in assets and the class of equity securities was held by fewer than 500 holders of record or (ii) the class of equity securities was held by fewer than 300 holders of record.[459] While the JOBS Act increased the held-of-record test for requiring registration for all issuers, it increased the 300 persons held-of-record test in Exchange Act section 12(g)(4) only for banks and bank holding companies, raising that threshold from 300 to 1,200 persons.[460] The JOBS Act did not increase the 300 persons held-of-record test for deregistration for issuers that are not banks or bank holding companies.

Under the JOBS Act, Exchange Act section 12(g)(5) was amended to provide that the term "held of record" does not include "securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act."[461] Congress directed the Commission to amend its Rule 12g5-1 definition of "held of record" to reflect this amendment to the statute.[462] Congress also directed the Commission to adopt safe harbor rules for issuers to follow in determining whether holders of their securities received the securities pursuant to "an employee compensation plan in transactions that were exempt from the registration requirements of section 5 of the Securities Act of 1933."[463] Securities sold in exempt crowdfunding offerings will also be excluded from the "held of record" computation in determining whether registration is required under Exchange Act section 12(g).[464]

455. *Id.* (to be codified at 15 U.S.C. § 77c(b)(2)(G)(ii)).
456. *See* 15 U.S.C. § 78*l*(g)(1) (2006); 17 C.F.R. § 240.12g-1 (2012).
457. JOBS Act § 501, 126 Stat. at 325 (to be codified at 15 U.S.C. § 78*l*(g)(1)(A)(i)–(ii)).
458. *Id.* § 601(a), 126 Stat. at 326 (to be codified at 15 U.S.C. § 78*l*(g)(1)(B)).
459. *See* 15 U.S.C. § 78o(g)(4) (2006); 17 C.F.R. § 240.12g-4(a)(1)–(2) (2012).
460. JOBS Act § 601(a)–(b), 126 Stat. at 326 (to be codified at 15 U.S.C. §§ 78*l*(g)(4), 78o(d)).
461. *Id.* § 502, 126 Stat. at 326 (to be codified at 15 U.S.C. § 78*l*(g)(5)).
462. *Id.* § 503, 126 Stat. at 326 (to be codified at 15 U.S.C. § 78*l* note).
463. *Id.* (to be codified at 15 U.S.C. § 78*l* note).
464. *Id.* § 303(a), 126 Stat. at 321 (to be codified at 15 U.S.C. § 78*l*(g)(6)).

## B. FAQs

Following enactment of the JOBS Act, the Commission staff moved quickly to provide market participants with guidance on various interpretative matters related to the Act by issuing and posting to its website various responses to frequently asked questions (FAQs).[465]

On April 10, 2012, the Division of Corporation Finance issued *Frequently Asked Questions: Confidential Submission Process for Emerging Growth Companies*, which provided immediate guidance to EGCs relying on the "IPO on-ramp" provisions of the JOBS Act, as well as on the timing and means of switching from the confidential submission to public filing.[466] Subsequently, on September 26, 2012, the staff announced that the Division of Corporation Finance had established an EDGAR-based system to accommodate confidential submissions by EGCs.[467]

The Commission also has provided additional guidance on various substantive matters relating to Title I of the JOBS Act. On April 16, 2012, the staff published the first series of responses to FAQs titled *Generally Applicable Questions on Title I of the JOBS Act*, which clarified the definition of EGC and the relevant dates for testing an issuer's status.[468] In May and September 2012, the staff provided additional guidance on the definition of EGC and its applicability to spin-offs, exchange offers, and other non-IPO transactions.[469] On August 22, 2012, the SEC's Division of Trading and Markets published *Frequently Asked Questions About Research Analysts and Underwriters* that addressed various research-related matters.[470] The FAQs reiterate that section 105 of the JOBS Act is intended to permit research analysts to participate in meetings with issuer management, but research analysts cannot engage in efforts to solicit banking business.[471] The FAQs also confirm that Regulation AC is not affected by the JOBS Act and clarify that the JOBS Act should be understood to apply to NYSE Rule 472 to the same extent as it applies to FINRA Rule 2711.[472]

465. *See Jumpstart Our Business Startups (JOBS) Act*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/spotlight/jobs-act.shtml (last modified Feb. 19, 2013).

466. *Jumpstart Our Business Startups Act: Frequently Asked Questions: Confidential Submission Process for Emerging Growth Companies*, U.S. Sec. & Exch. Comm'n (Apr. 10, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfjumpstartfaq.htm.

467. *Draft Registration Statements to Be Submitted and Filed on EDGAR*, U.S. Sec. & Exch. Comm'n (Sept. 26, 2012), http://www.sec.gov/divisions/corpfin/cfannouncements/drsfilingprocedures.htm.

468. *Jumpstart Our Business Startups Act: Frequently Asked Questions—Generally Applicable Questions on Title I of the JOBS Act*, U.S. Sec. & Exch. Comm'n (Apr. 16, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm (Questions 1–17).

469. *Jumpstart Our Business Startups Act: Frequently Asked Questions—Generally Applicable Questions on Title I of the JOBS Act*, U.S. Sec. & Exch. Comm'n (Sept. 28, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm (Questions 42–54); *Jumpstart Our Business Startups Act: Frequently Asked Questions—Generally Applicable Questions on Title I of the JOBS Act*, U.S. Sec. & Exch. Comm'n (May 3, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm (Questions 18–41).

470. *Jumpstart Our Business Startups Act: Frequently Asked Questions About Research Analysts and Underwriters*, U.S. Sec. & Exch. Comm'n (Aug. 22, 202), http://www.sec.gov/divisions/marketreg/tmjobsact-resarchanalystsfaq.htm.

471. *See id.* (Questions 1, 4–5).

472. *See id.* (Questions 6, 11–12).

On February 5, 2013, the Staff of the Division of Trading and Markets published a series of FAQs titled *Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, addressing certain broker-dealer matters arising in connection with Title II of the JOBS Act.[473] This guidance clarifies that the Title II provision relating to matchmaking sites does not require further rulemaking, but notes that a platform cannot permit an issuer to conduct a general solicitation in a Rule 506 offering until the Commission promulgates its final rules. The FAQs note that the exemption from broker-dealer registration for this purpose is applicable only when securities are offered and sold pursuant to Rule 506. The FAQs also address compensation and note that "Congress conditioned the exemption on a person and its associated persons not receiving any "compensation" in connection with the purchase or sale of such security." The staff interprets the term "compensation" broadly, to include any direct or indirect economic benefit to the person or any of its associated persons; however, a venture fund may operate a matchmaking site.

On April 23, 2012, the Division of Corporation Finance issued *Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act*, which emphasized that the Commission must adopt rules to implement the crowdfunding exemption and, until it did so, any offers or sales purporting to rely on the exemption would be unlawful.[474] On May 7, 2012, the Division of Trading and Markets issued *Frequently Asked Questions About Crowdfunding Intermediaries*, which addressed a number of issues related to crowdfunding intermediaries or funding portals.[475]

On April 11, 2012, the Division of Corporation Finance issued *Frequently Asked Questions: Changes to the Requirements for Exchange Act Registration and Deregistration*, which confirmed that the Title V and Title VI provisions raising the Exchange Act registration/deregistration thresholds were, for the most part, immediately effective.[476] This provides some companies with the ability to avoid registration in 2012 and, specifically with regard to bank holding companies, to terminate their registration/reporting obligation.[477] Additionally, the staff noted that if a bank holding company with a class of equity securities held of record by less than 1,200 persons as of the first day of the current fiscal year has a registration statement that is updated during the current fiscal year pursu-

473. *Jumpstart Our Business Startups Act: Frequently Asked Questions—Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, U.S. SEC. & EXCH. COMM'N (Feb. 5, 2013), http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.

474. *Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm (last modified Apr. 23, 2012).

475. *Jumpstart Our Business Startups Act: Frequently Asked Questions About Crowdfunding Intermediaries*, U.S. SEC. & EXCH. COMM'N (May 7, 2012), http://www.sec.gov/divisions/marketreg/tmjobsact-crowdfundingintermediariesfaq.htm.

476. *Jumpstart Our Business Startups Act: Frequently Asked Questions—Changes to the Requirements for Exchange Act Registration and Deregistration*, U.S. SEC. & EXCH. COMM'N (Apr. 11, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-12g.htm.

477. *See id.* (Questions 1–3).

ant to Securities Act section 10(a)(3), but under which no sales have been made during the current fiscal year, then the bank holding company may be eligible to seek no-action relief to suspend its section 15(d) reporting obligation.[478] The staff has granted no-action letters.[479]

## C. Studies

### 1. The Commission's Report to Congress on Decimalization as Required by Section 106 of the JOBS Act

On July 20, 2012, the staff of the Commission delivered to Congress its report on decimalization, as required by section 106 of the JOBS Act.[480] Section 106(b) of the JOBS Act requires the Commission to examine the impact of decimalization (i.e., the trading and quoting of securities in increments of $0.01) on IPOs and on liquidity for the securities of small- and middle-capitalization companies.[481] If the Commission concludes that securities of EGCs should be quoted or traded using a minimum increment higher than $0.01, then pursuant to section 106(b) of the JOBS Act, it may designate a higher minimum increment between $0.01 and $0.10.[482]

In conducting its study, the staff of the SEC utilized a three-pronged approach[483] and concluded that, while decimalization may be one of a number of factors contributing to a decline in the number of IPOs and in the liquidity of the securities of small- and middle-capitalization companies, there is not sufficient empirical evidence to isolate the effect of decimalization from other relevant factors.[484] The staff recommended that the Commission "not proceed with the specific rulemaking to increase tick sizes, as provided for in section 106(b) of the JOBS Act, but should consider additional steps that may be needed to determine whether rulemaking should be undertaken in the future."[485] The staff further recommended that the SEC take additional steps, including soliciting the views of investors, companies, market professionals, and academics on how best to study decimalization's effects on IPOs, trading, and liquidity of the securities of small- and middle-capitalization companies.[486]

478. *See id.* (Question 4).

479. *See, e.g.*, Birmingham Bloomfield Bancshares, Inc., SEC No-Action Letter, 2013 WL 392161 (Jan. 30, 2013).

480. U.S. Sec. & Exch. Comm'n, Report to Congress on Decimalization (July 2012) [hereinafter 106 Report], *available at* http://www.sec.gov/news/studies/2012/decimalization-072012.htm.

481. JOBS Act § 106(b), 126 Stat. at 312 (to be codified at 15 U.S.C. § 78k-1(c)(6)(A)).

482. *Id.* (to be codified at 15 U.S.C. § 78k-1(c)(6)(B)).

483. The Commission conducted its study by: (i) reviewing empirical studies regarding tick size and decimalization; (ii) participating in, and reviewing materials prepared in connection with, discussions concerning the impact of market structure on small- and middle-capitalization companies, and on IPOs as part of the SEC Advisory Committee on Small and Emerging Companies; and (iii) surveying tick-size conventions in foreign markets. 106 Report, *supra* note 480, at 3.

484. *Id.* at 19–21.

485. *Id.* at 22.

486. *Id.*

#### 2. The Commission's Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3), as Required by Section 504 of the JOBS Act

On October 15, 2012, the staff of the Commission released its *Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3)*, as required by section 504 of the JOBS Act (the "*504 Report*").[487] Under section 504 of the JOBS Act, the Commission was required to "examine its authority to enforce Rule 12g5-1 to determine if new enforcement tools are needed to enforce the anti-evasion provision contained in subsection (b)(3) of the rule."[488] Rule 12g5-1 of the Exchange Act sets forth when securities are "held of record" for purposes of determining whether a company has reached the threshold number of shareholders requiring it to register under section 12(g) of the Exchange Act.[489] In the *504 Report*, the staff concluded that the current tools used to enforce the anti-evasion provision contained in Rule 12g5-1(b)(3) of the Exchange Act (i.e., voluntary requests for documents, interviews, subpoenas, and cease-and-desist proceedings) were adequate.[490] The staff further noted that, because the changes to the "holder of record" requirements under the JOBS Act were just recently enacted, it will take some time to assess any impact on possible circumvention efforts.[491] Accordingly, the staff did not suggest any further legislative action.[492]

### D. Proposed Amendments to Rule 506

The Commission proposed new Rule 506(c), which would permit the use of general solicitation in Rule 506 offerings, subject to certain conditions:

- The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;[493]
- All purchasers of securities must be accredited investors at the time of the sale of the securities;[494] and
- All terms and conditions of Rule 501 and Rules 502(a) and 502(d) must be satisfied.[495]

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487. U.S. Sec. & Exch. Comm'n, Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3) (Oct. 15, 2012) [hereinafter 504 Report], *available at* http://www.sec.gov/news/studies/2012/authority-to-enforce-rule-12g5-1.pdf.

488. JOBS Act § 504, 126 Stat. at 326.

489. 17 C.F.R. § 240.12g5-1 (2012).

490. 504 Report, *supra* note 487, at 33–34.

491. *Id.* at 34.

492. *Id.*

493. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 54464, 54481 (proposed Sept. 5, 2012) (to be codified at 17 C.F.R. § 230.506(c)(2)(ii)). The Commission noted that broker-dealers who participate with issuers in offerings relying on the proposed Rule 506(c) would continue to be subject to the FINRA rules regarding communications with the public. *Id.* at 54467 n.36.

494. *Id.* at 54481 (to be codified at 17 C.F.R. § 230.506(c)(2)(i)).

495. *Id.* (to be codified at 17 C.F.R. § 230.506(c)(1)).

### 1. Investor Verification

The Commission's proposal provides for a flexible approach to investor verification acknowledging that "reasonable steps" to verify investor status may differ depending on the facts and circumstances.[496] To that end, the Commission provides in its proposal a non-exhaustive list of factors that may be appropriate to consider, which include:

- *The nature of the purchaser*. Accredited investors could include broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities.[497]
- *The nature and amount of information about the purchaser*. "The more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa."[498]
- *The nature of the offering*. Issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or e-mail.[499] By contrast, less intrusive verification steps may be required to the extent that solicitations are directed at investors that are pre-screened by a reliable third party.[500]

The Commission also confirmed that Congress did not intend to eliminate the existing "reasonable belief" standard in Rule 501(a) of Regulation D or for Rule 506 offerings.[501] If a person were to supply false information to an issuer claiming status as an accredited investor, the issuer would not lose the ability to rely on the proposed Rule 506(c) provided the issuer "took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor."[502]

### 2. Form D

Item 6 of Form D currently requires the issuer to identify the claimed exemption or exemptions for the offering from among Rule 504's paragraphs and subparagraphs, Rule 505, Rule 506, and section 4(5), as applicable.[503] The

496. *Id.* at 54467.
497. *Id.* at 54467–68.
498. *Id.* at 54468. The Commission is mindful of the concerns that the "reasonable steps" required of issuers may infringe on the privacy of potential accredited investors. *Id.* The Commission tried to address these concerns by stating that issuers may rely on publicly available information such as purchaser's compensation described in a proxy statement in order to verify accredited status or through independent verification of a person's status as an accredited investor by a third party, such as a broker-dealer, attorney, or accountant, so long as there is a reasonable basis to rely on the third-party verification. *Id.*
499. *Id.* at 54469.
500. *Id.*
501. *Id.* at 54471.
502. *Id.* at 54471–72.
503. *Id.* at 54472 & n.81.

Commission proposed revising Form D to add a separate check box for issuers to indicate that they are claiming an exemption under new Rule 506(c).[504] Requiring an issuer to supply this information would assist the Commission's efforts to monitor the use of general solicitation in Rule 506(c) offerings and the size and frequency of this offering market, as well as help identify the market practices being used by issuers in order to assess the effectiveness of the differing verification practices.[505]

### 3. Private Funds

The Commission addressed an important issue regarding the effect of section 201(b) of the JOBS Act on privately offered funds.[506] The Commission confirmed that section 201(b) of the JOBS Act permits privately offered funds to make a general solicitation under new Rule 506(c) without losing the ability to rely on the exclusions from the definition of an "investment company" available under section 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.[507]

### 4. Amendments to Rule 144A

The JOBS Act directed the Commission to amend its rules to provide that securities sold pursuant to Rule 144A may be offered to persons other than qualified institutional buyers, or QIBs, including by means of general solicitation, provided that securities are sold only to persons that the seller reasonably believes is a QIB.[508] The Commission proposed to amend the rule to require only that the securities are sold to a purchaser that the seller reasonably believes is a QIB, even by way of general solicitation.[509]

### 5. Offshore Offerings

The Commission noted that the JOBS Act did not address the impact of the use of general solicitation on the availability of the Regulation S[510] safe harbor for concurrent unregistered offerings inside and outside the United States.[511]

504. *Id.* at 54472.

505. *Id.*

506. *Id.*

507. *See id.* Section 3(c)(1) of the Investment Company Act of 1940 excludes from the definition of "investment company" any issuer whose outstanding securities are beneficially owned by not more than 100 beneficial owners, 15 U.S.C. § 80a-3(c)(1) (2006), and section 3(c)(7) of the Investment Company Act of 1940 excludes from that definition any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers." 15 U.S.C. § 80a-3(c)(7) (2006). Both sections provide that issuers may rely on those exclusions only if they do not make or propose to make a public offering of securities. 15 U.S.C. § 80a-3(c)(1),(7) (2006).

508. JOBS Act § 201(a)(2), 126 Stat. at 313 (to be codified at 15 U.S.C. § 77d note).

509. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. at 54481 (to be codified at 17 C.F.R. § 230.144A).

510. 17 C.F.R. §§ 230.901–230.905 (2012).

511. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. at 54474.

Consistent with past practice, the Commission confirmed that it will not integrate offshore offerings conducted in compliance with Regulation S with domestic unregistered offerings conducted in compliance with Rule 506 or Rule 144A.[512]

### 6. Conclusion

It is important to point out that the Commission retained existing Rule 506(b), which gives issuers the ability to conduct Rule 506 offerings without the use of general solicitation.[513] This may be important for those issuers that do not want to use general solicitation in order to avoid the burden of having to take additional steps to verify the accredited investor status of purchasers or want to sell securities to non-accredited investors meeting the rule's sophistication requirements.[514]

In proposing these amendments, the Commission did not address particular standards for general solicitations or advertisements for issuers.[515] The Commission, however, did leave the door open for future rulemaking in this area by noting that it was not adopting such suggested amendments "at this time."[516]

512. *Id.*
513. *Id.* at 54467.
514. *See id.*
515. *Id.* at 54466.
516. *Id.*

# Accounting Developments 2012

## A. Revenue Deferral with Refundable Advance Fees in Continuing Care Retirement Communities

In July 2012, the Financial Accounting Standards Board (the "FASB") released Accounting Standards Update ("ASU") No. 2012-01,[1] which advised that a continuing care retirement community entity should "classify an advance fee as deferred revenue when [it] has a resident contract that provides for payment of the refundable advance fee upon re-occupancy by a subsequent resident, which is limited to the proceeds of re-occupancy."[2] Conversely, those refundable advance fees that are not limited to the proceeds of re-occupancy, but are still contingent upon re-occupancy by a subsequent resident, should be accounted for and reported as a liability.[3] The FASB indicated that ASU No. 2012-01 was designed to clarify prior guidance in Subtopic 954-430 which, the FASB noted, provided an unclear mandate that required continuing care retirement communities to recognize deferred revenue in particular circumstances when they receive refundable advance fees.[4]

The FASB justified this change as a step in its effort to eliminate diversity in financial reporting across the spectrum of continuing care retirement community providers.[5] The standards in ASU No. 2012-01 are set to phase in at different points, depending on whether an entity is public or nonpublic. For public entities, the amendments in the ASU become mandatory for fiscal periods beginning on December 15, 2012, and beyond.[6] Nonpublic entities receive more lenient treatment and may postpone compliance until fiscal years beginning on December 15, 2013, and beyond.[7] Regardless of when the standards in ASU No. 2012-01 are adopted, however, entities should apply them retrospectively.[8] In other words, the cumulative effect of the new accounting treatment should be applied to prior periods and recorded in retained earnings. Early adoption of the

1. Fin. Accounting Standards Bd., Accounting Standards Update No. 2012-01, Health Care Entities (Topic 954): Continuing Care Retirement Communities—Refundable Advance Fees (July 2012) [hereinafter ASU No. 2012-01].
2. *Id.*
3. *Id.*
4. *Id.* at 1.
5. *Id.* at 2.
6. *Id.*
7. *Id.*
8. *Id.*

accounting standards in ASU No. 2012-01 is permitted for both public and nonpublic entities.[9]

## B. Impairment Testing for Indefinite Lived Intangible Assets

Impairment testing for various assets constitutes an important part of accurate balance sheet presentation yet imposes substantial burdens on reporting entities in deciding which assets merit such write-downs in value. In July 2012, the FASB addressed this conflict with the release of ASU No. 2012-02.[10] ASU No. 2012-02 lightens the burden on reporting entities by allowing them to forego quantitative impairment testing of an intangible asset if, after conducting a qualitative, totality-of-the-circumstances test, they find that it is more likely than not that the asset is unimpaired.[11] Making this judgment requires a reporting entity to evaluate all the relevant facts and circumstances surrounding the fair value of the asset. Unlike the quantitative valuation test, it does not require the determination of an absolute figure of value; rather, this qualitative test produces a judgment as to whether a sufficient reduction in value has, in all likelihood, occurred or not occurred.[12] Nonetheless, in circumstances in which this new qualitative test produces a judgment that a reduction in fair value to a point below carrying value probably has occurred, the reporting entity must proceed with the usual quantitative valuation test to determine whether carrying value actually exceeds the fair value of the asset.[13] If application of the quantitative test leads to a conclusion that carrying value is larger than fair value, an impairment charge will be necessary.[14] As a whole, this approach provides reporting entities with an option consistent with the approach made available for assessing goodwill impairment under ASU No. 2011-08.[15]

Before the release of ASU No. 2012-02, reporting entities were required to test indefinite-lived intangible assets for impairment at least annually by producing estimates of fair value, which were then compared with carrying value.[16] However, implementation of this procedure entailed significant costs and expense, even for assets that faced little likelihood of impairment, as revealed to the FASB through feedback from reporting entities.[17] Ideally, ASU No. 2012-02 eliminates much of this wasteful procedure and expense by striking the requirement of annual valuation testing for all assets.[18] Quantitative impairment testing will now only be necessary for those assets that are deemed, through the qualitative

9. *Id.*
10. Fin. Accounting Standards Bd., Accounting Standards Update No. 2012-02, Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment (July 2012) [hereinafter ASU No. 2012-02].
11. *Id.* at 1.
12. *Id.* at 2.
13. *Id.*
14. *Id.* at 1.
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*

test, to be likely to have suffered a reduction in fair value to a point below carrying value.[19] According to the FASB, the "more-likely-than-not threshold is defined as having a likelihood of more than 50 percent."[20] As noted above, if the qualitative test fails to produce a conclusion that the asset is more than likely not impaired (using the 50 percent threshold), the entity must proceed with the impairment test as usual.[21]

Entities need not necessarily conduct the qualitative test, however. As an alternative, reporting entities will still be allowed to conduct standard quantitative impairment testing annually instead of first conducting the preliminary qualitative test.[22] If a reporting entity chooses to forego the qualitative test in one period, it may resume its use of the qualitative test in any subsequent period.[23] In other words, this standard provides a potentially less time-consuming option for testing that may be adopted at any time after the effective period of ASU No. 2012-02.

The amendments in ASU No. 2012-02 apply simultaneously to public and private entities. All entities may implement this standard for fiscal years beginning after September 15, 2012. However, in certain circumstances application may be different for public and nonpublic entities. Specifically, nonpublic entities may adopt the standards before July 27, 2012, if their financial statements for the most recent annual or interim period have not been available for issuance.[24] Public entities may adopt the standard prior to July 27, 2012, if their financial statements for the most recent annual or interim period have not yet been issued.[25] Furthermore, as noted above, entities are allowed to continue the practice of annual quantitative impairment testing (without the initial qualitative impairment testing) if they wish to do so.

Despite the FASB's stated goal of greater convergence with accounting standards from the International Accounting Standards Board ("IASB"), ASU No. 2012-02 will not serve to harmonize further accounting standards between entities that choose to follow United States generally accepted accounting practices ("U.S. GAAP") and those that follow International Financial Reporting Standards ("IFRS").[26] International Accounting Standard ("IAS") 36—the International Financial Reporting Standards counterpart for assessing impairment in long-lived intangible assets—requires that "[t]he impairment test must be performed at least annually regardless of whether there is any indication of impairment and in between annual tests whenever there is an indication of impairment."[27] Therefore, International Financial Reporting Standards hew more closely to the standard that ASU No. 2012-02 replaces. Recognizing this disconnect, the FASB

19. *Id.*
20. *Id.*
21. *Id.* at 2.
22. *Id.*
23. *Id.*
24. *Id.* at 3.
25. *Id.*
26. *Id.*
27. *Id.*

concludes that convergence in this instance is "beyond the scope of [ASU No. 2012-02] and can only be approached by more broadly addressing these and other differences in impairment guidance between U.S. GAAP and International Financial Reporting Standards."[28]

## C. Classifying Proceeds from the Sale of Donated Financial Assets in Not-for-Profit Entities

On the consensus of the FASB Emerging Issues Task Force, in October 2005, the FASB issued ASU No. 2012-05,[29] which updated guidance for not-for-profit entities in their accounting for the sale of donated financial assets when reporting on the statement of cash flows.[30] Previously, not-for-profit entities reported such transactions in a variety of ways, with no clear convention for the appropriate treatment.[31] Addressing this, ASU No. 2012-05 provides clear rules clarifying that entities are to account for the proceeds from sale of financial assets the same as they account for cash donations, assuming that those financial assets are donated without any not-for-profit imposed limitations for sale and are converted nearly immediately into cash.[32] Cash receipts from the sale of such financial assets "should be classified as cash inflows from operating activities, unless the donor restricted the use of the contributed resources to long-term purposes[.]"[33] In the latter case, entities should classify such cash receipts as a cash flow from financing activities.[34] For any other types, entities should report the cash flows as proceeds of investing activities.[35]

ASU No. 2012-05 is effective on a forward-looking basis for fiscal years beginning on June 15, 2013, and after, as well as for interim periods occurring within those years.[36] Entities may also apply the standard retrospectively to all prior periods upon the date of adoption.[37] However, early adoption for fiscal years starting before October 22, 2012, is allowed only if a not-for-profit entity's financial statements for the periods covered have not been made publicly available.[38]

International Financial Reporting Standards are not explicitly designed to produce accounting principles for not-for-profit entities, so there is no clear takeaway with regard to how ASU No. 2012-05 addresses differences between International Financial Reporting Standards and GAAP.[39] Nonetheless, International

28. *Id.*
29. Fin. Accounting Standards Bd., Accounting Standards Update No. 2012-05, Statement of Cash Flows (Topic 230): Not-for-Profit Entities Classification of the Sale Proceeds of Donated Financial Assets in the Statement of Cash Flows (Oct. 2012) [hereinafter ASU No. 2012-05].
30. *Id.* at 1.
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.* at 2.
37. *Id.*
38. *Id.*
39. *Id.*

Financial Reporting Standards employ a principles-based system for the statement of cash flows, whereby operating cash flows are defined as those cash flows that are "derived from the principal revenue producing activities of the entity."[40] For related reasons, sales of financial assets are usually, although not categorically, recognized as investing activities.[41] Thus, ASU No. 2012-05 produces different guidance for classifying such cash flows from sales of financial assets for not-for-profit entities.

## D. Subsequent Accounting for Indemnification Assets Recognized at Acquisition

In October 2012, the FASB issued ASU No. 2012-06,[42] which provides insight into a problem that has recently faced acquirers during the financial crisis and its aftermath: notably, how an entity accounts over time for indemnification assets resulting from a government-assisted acquisition of troubled financial institutions. Such an indemnification asset arises when a purchaser buys a troubled bank or other financial institution in tandem with a loss-sharing agreement from an arm of the government, such as the Federal Deposit Insurance Corporation or National Credit Union Administration.[43] When a reporting entity receives an indemnification asset from the government in such a transaction, the entity should account for any change in the expected cash flows to be collected on the same basis as the asset itself.[44] Any amortization that occurs at later points due to this change should be allocated over the lesser of the contractual term of the indemnification agreement or the remaining life of the asset.[45]

The amendments in ASU No. 2012-06 affect all entities that recognize indemnification assets of the type discussed herein.[46] For both public and nonpublic entities, compliance with ASU No. 2012-06 becomes mandatory for fiscal years beginning on or after December 15, 2012, as well as any interim periods contained therein. The standards should be applied prospectively to any indemnification assets acquired in the future and should be applied to any indemnification assets existing as of the date of adoption.[47] Prior to ASU No. 2012-06, no direct guidance was available for such indemnification assets, and there existed significant diversity in practice among reporting entities.

For the most part, International Financial Reporting Standards and GAAP align with respect to the accounting treatment of indemnification assets; essentially, these assets should be subsequently measured on the same basis as the

40. *Id.*
41. *Id.*
42. Fin. Accounting Standards Bd., Accounting Standards Update No. 2012-06, Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution (Oct. 2012) [hereinafter ASU No. 2012-06].
43. *Id.* at 1.
44. *Id.*
45. *Id.*
46. *Id.* at 2.
47. *Id.*

indemnified liability or asset.[48] But specific guidance regarding the measurement itself may not be completely aligned across International Financial Reporting Standards and GAAP, particularly for purchases that involve credit-impaired assets.[49] Nonetheless, the FASB and IASB are currently cooperating in deliberations regarding these measurements, and this may result in convergence in subsequent measurement of indemnification assets involving troubled financial institutions and government loss-sharing agreements.[50]

## E. Accounting for Information Obtained After the Measurement Date and Its Inclusion in Impairment Analysis of Unamortized Film Costs

In ASU No. 2012-07,[51] the FASB provided guidance for impairment analysis of unamortized film costs in the entertainment industry, in situations in which information arises after the balance sheet measurement date.[52] The update was made to reconcile an apparent conflict between Topic 926 and the guidance for fair value measurement in Topic 820, Fair Value Measurement.[53] Before ASU No. 2012-07, entities were required to apply a rebuttable presumption that information arising after the balance sheet date should be incorporated into the balance sheet impairment analysis, unless the reporting entity can rebut the presumption that such information did not exist as of the balance sheet date.[54] This update, however, alters prior practice. Following this update, entities need no longer apply the rebuttable presumption that information leading to the write-off of unamortized film costs after the balance sheet date in fact did exist on the balance sheet date.[55] Instead, entities should assess the "fair value" as of the balance sheet date, assessed with information available at that point, pursuant to the guidance embedded in Topic 820.[56] The update also removes the requirement that impairment analysis should be altered to incorporate the effect of any changes in estimates resulting from the consideration of subsequent evidence, unless such information would have been considered by market participants at the measurement date.[57]

Nonetheless, clients should be cautioned against applying ASU No. 2012-07 too aggressively. Consistent with typical assessments of fair value, "[a]mending the guidance to remove the rebuttable presumption does not imply that the sub-

48. *Id.*
49. *Id.*
50. *Id.*
51. Fin. Accounting Standards Bd., Accounting Standards Update No. 2012-07, Entertainment—Films (Topic 926): Accounting for Fair Value Information that Arises After the Measurement Date and Its Inclusion in the Impairment Analysis of Unamortized Film Costs (Oct. 2012) [hereinafter ASU No. 2012-07].
52. *Id.* at 1.
53. *Id.*
54. *Id.*
55. *Id.* at 2.
56. *Id.*
57. *Id.*

sequent evidence should be ignored in estimating a fair value measurement."[58] This is the case because ASU No. 2012-07 does not remove an entity's responsibility to "analyze and consider any relevant subsequent events and information to assess whether the fair value measurement reflects all relevant information and assumptions that market participants would have considered under the current conditions at the measurement date."[59]

The requirements phase-in at different times for different entities. Entities that file with the Commission must adopt the amendments for impairment assessments performed on or after December 15, 2012.[60] All others must comply for all impairment assessments performed on or after December 15, 2013.[61] All amendments resulting from ASU No. 2012-07 should be applied prospectively.[62] Early adoption is allowed, including for impairment assessments performed as of a date before October 24, 2012, if, "for SEC filers, the entity's financial statements for the most recent annual or interim period have not yet been issued or, for all other entities, have not yet been made available for issuance."[63]

58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.* at 3.

# Caselaw Developments 2012*

## Overview

*Supreme Court*. While failing to decide whether the two-year period in which a plaintiff must bring a section 16(b) claim is a statute of limitations or a statute of repose, the Supreme Court ruled that a defendant's failure to file a section 16(a) report does not categorically toll that period and that the commencement of that period does not await the plaintiff's actual discovery of the claim.[1]

*Circuit courts*. The courts of appeals produced important decisions clarifying insider trading law, addressing among other things the complexities of determining when an insider has made a purchase or sale that counts for section 16(b) calculations. The courts authored decisions significant to the life science industry, revolving around the disclosure of U.S. Food and Drug Administration ("FDA") inspection comments and announcements of clinical trial results. Item 303 disclosure, auditor scienter, and issues growing out of criminal cases and enforcement actions by the U.S. Securities and Exchange Commission ("SEC" or "Commission") provided fodder for the circuit courts—with questions ranging from the interpretation of the federal securities crime added by the Sarbanes-Oxley Act ("SOX") to what conduct is sufficient to satisfy the "substantial assistance" element of aiding and abetting, to whether an attorney's violation of state professional conduct rules suffices to bar the attorney from practice before the Commission. The courts addressed scienter pleading under the Private Securities Litigation Reform Act ("PSLRA") and how the PSLRA's statutory demand that plaintiffs plead and prove loss causation interacts with the rescission remedy in Rule 10b-5 cases. In other decisions, the courts found disclosures sufficient to defeat manipulation claims, held that a court can certify a Rule 23(b)(3) settlement class even when the plaintiff cannot show that a fraud on the market forecloses the need to prove individual reliance, and ruled that employees of an issuer's contractors do not enjoy SOX whistleblower protection.

*Insider trading*. The Second Circuit held that, in order to have scienter, a tipper must know or be recklessly ignorant in not knowing that the information the

* The caselaw developments section covers opinions decided from December 1, 2011, through the end of November 2012. Where this portion of the annual review expresses opinions, those opinions are those of the author of the caselaw developments, William O. Fisher, and not necessarily the opinions of other authors contributing to the annual review, or of members of the subcommittee producing the review, or of the American Bar Association.

1. *See infra* notes 29–52 and accompanying text.

tipper transmits is both material and nonpublic and that transmitting the information violates a duty.[2] The Second Circuit held, in a second case, that confirmation of general market speculation may be material if the confirmation provides details or emanates from a reliable source.[3]

*Section 16(b)*. The Second Circuit applied complicated rules to determine when a more-than-ten-percent shareholder had "purchased" stock through a series of events involving the successive replacement of a convertible debt instrument, which included both fixed and floating prices for conversion—with the same opinion addressing whether the resulting equity acquisition was exempt from section 16(b) computation because it was "in connection with a debt previously contracted."[4] The Second Circuit held that an equity acquisition by a more-than-ten-percent shareholder was not exempt from section 16(b) computation simply because the shareholder bought at the instigation of the issuer's board.[5]

*Disclosure of product quality control problems and government inspection reports*. The Eighth Circuit held that quality control problems could create a "known uncertainty" that an issuer must disclose under Item 303, even before the issuer knows the extent of the business damage the quality problems will cause.[6] In a second case, that circuit held that a pharmaceutical company could violate the securities laws by stating in Form 10-Ks that the company was in material compliance with FDA regulations and manufacturing practices when the FDA was continually warning the company, through Form 483s, that its drug production suffered from serious and pervasive problems.[7]

*Disclosure of clinical trial results*. The Ninth Circuit rejected a plaintiff's contention that a pharmaceutical company's announcement of results from a clinical trial was false and misleading (i) because a statistical analysis different from the one the company employed would have shown the tested drug was not effective and (ii) because the company in a press release and accompanying conference call expressly limited its disclosure of side effects to effects of moderate or greater severity.[8]

*Criminal cases*. The Second Circuit interpreted the new securities crime included in SOX—18 U.S.C. § 1348—by reference to authority under the mail and wire fraud statutes and, in the same opinion, addressed both the definition of confidential information in the context of a prosecution based on deprivation of honest services and the reach of the criminal forfeiture statute.[9] In a second decision, the same circuit found abuse in admitting graphic evidence that seemed to attribute a company's entire stock price drop to the fraud the government was

2. *See infra* notes 55–87 and accompanying text.
3. *See infra* notes 88–104 and accompanying text.
4. *See infra* notes 110–49 and accompanying text.
5. *See infra* notes 150–73 and accompanying text.
6. *See infra* notes 176–92 and accompanying text.
7. *See infra* notes 193–210 and accompanying text.
8. *See infra* notes 211–35 and accompanying text.
9. *See infra* notes 238–61 and accompanying text.

prosecuting and, in addition, held both (i) that a conscious avoidance instruction was appropriate even though the avoided knowledge was how a contractual counterparty would record a transaction in its accounting records, and (ii) that a lawyer could not defend on the basis that he consulted with his superior on ethical issues involved in the deal where the lawyer simply sent his superior a factual report.[10]

*SEC enforcement actions*. The Eleventh Circuit held that the materiality of misrepresentations did not—simply because the Commission was suing a brokerage house as an entity—depend on the number of customers to whom the misrepresentations were made.[11] The D.C. Circuit held that the SEC could bar an attorney from practice before the Commission—under the agency's Rule 102(e)—on the basis of the lawyer's violation of state ethics rules and could do so even though the state bar had not disciplined the attorney.[12]

*PSLRA pleading*. In two opinions, the First Circuit found scienter allegations inadequate in part because the plaintiffs pled a poor case that the undisclosed facts were material.[13] The Seventh Circuit found scienter allegations inadequate where the defendant had represented that a company had "substantial liquidity" with which to meet margin calls on mortgage securitizations, in part because the defendant had included a warning that the liquidity might not be sufficient.[14] That circuit also held that a plaintiff failed to plead the scienter of a medical device company and its officers where the defendants attributed adverse outcomes in the United States to doctor implantation technique rather than device design, and where the court concluded that an inference of fraud was not as strong as the inference that the defendants' statements reflected a judgment that, based on a higher rate of failures in the United States compared with a far lower failure rate with the same device in Europe, implantation technique in the United States, rather than design, was the likely cause of the comparatively poor U.S. results.[15] In the same case, the court found no deliberate deception where an executive had responded to a question about both FDA warning letters and FDA Form 483s by simply saying that the company had not received any warning letters, without mentioning that FDA inspectors had made 483 observations.[16]

*Loss causation*. The Second Circuit held that a stock price rebound, after a stock price drop following a corrective disclosure, did not defeat loss causation at the pleading stage.[17] The Eleventh Circuit found that an expert failed to support loss causation by an event study that controlled for (i) stock market movement generally and (ii) the price movement of stocks issued by companies in the defendants' industry—but failed to control for the deterioration of the local market

10. *See infra* notes 262–81 and accompanying text.
11. *See infra* notes 284–301 and accompanying text.
12. *See infra* notes 302–21 and accompanying text.
13. *See infra* notes 334–69 and accompanying text.
14. *See infra* notes 370–83 and accompanying text.
15. *See infra* notes 384–97 and accompanying text, particularly at notes 384–86.
16. *See infra* notes 384–97 and accompanying text, particularly at notes 391–97.
17. *See infra* notes 404–11 and accompanying text.

in which the defendants operated.[18] The Sixth Circuit held that the PSLRA's statutory requirement for loss causation does not foreclose a rescission remedy on a claim under Rule 10b-5,[19] and the Ninth Circuit held that—when seeking rescission on such a claim—the plaintiff must prove loss causation.[20]

*Manipulation*. The Second Circuit held that a claim, under Rule 10b-5(a) and (c), for manipulation of the market for auction rate securities required that the defendant deceived investors as to how its actions affected the market and that no deception could be shown in light of the defendant's disclosures (i) that it had made supporting bids in auctions to affect the rates at which the auctions cleared but (ii) that it was not obligated to, and might cease to, place such bids.[21]

*Class actions*. The Second Circuit held that, where the case revolved around alleged underwriting failures at mortgage originators, the purchaser of certificates out of one tranche issued by one trust holding a mortgage pool had "class standing" to sue on behalf of all other purchasers of certificates from all tranches issued by that trust, and related trusts holding mortgages originated by specific financial companies about which the complaint made particularized allegations of underwriting abuse.[22]

*Miscellaneous cases*. The Ninth Circuit held that the territorial reach of the Securities Act—in transactions involving non-exchange-traded securities—can depend on where the deal closes,[23] and the Second Circuit held that the reach of Rule 10b-5 in such transactions can be determined by the place at which the parties became irrevocably committed to the sale.[24] The Second Circuit held that a district court could certify a Rule 23(b)(3) *settlement* class in a Rule 10b-5 case, without the plaintiff showing that proof of individual reliance by class members was unnecessary.[25] In light of the brokerage/customer agreements involved, the Second Circuit found no Rule 10b-5 violation in a broker's use of securities in customer accounts to secure financing for the broker.[26] The Eighth Circuit held that a claim under section 36(b) of the Investment Company Act cannot rest solely on an adviser's allegedly unfair conduct during fee negotiations with the fund.[27] And the First Circuit found that the SOX whistleblower protections did not extend to employees of contractors to public companies.[28]

## U.S. Supreme Court

*Supreme Court holds that the two-year period in which short-swing profit claim must be brought is not automatically tolled until defendant files section 16(a) report,*

18. *See infra* notes 412–21 and accompanying text.
19. *See infra* notes 422–32 and accompanying text.
20. *See infra* notes 433–48 and accompanying text.
21. *See infra* notes 449–74 and accompanying text.
22. *See infra* notes 475–94 and accompanying text.
23. *See infra* notes 501–03 and accompanying text.
24. *See infra* notes 504–09 and accompanying text.
25. *See infra* notes 510–18 and accompanying text.
26. *See infra* notes 519–31 and accompanying text.
27. *See infra* notes 532–37 and accompanying text.
28. *See infra* notes 538–41 and accompanying text.

*and runs out two years after plaintiff should have discovered facts*. The year 2012 yielded one rather disappointing Supreme Court decision interpreting federal securities law. Section 16(b) of the Exchange Act creates a claim for issuers of equity securities registered under section 12 of that Act.[29] Such issuers may recover—from any officer, director, or beneficial owner of more than 10 percent of any class of such security—the profits from that owner's purchase or sale, or sale and purchase, of that security within any six-month period.[30] The statute provides that "no such suit shall be brought more than two years after the date such profit was realized."[31] In *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, the Court characterized the just-quoted provision as a "statute of repose,"[32] a characterization that would mean that the two-year period could not be extended by equitable tolling.[33]

The Court revisited the *Lampf* dictum last year in *Credit Suisse Securities (USA) LLC v. Simmonds*.[34] The Court found itself split four to four (Chief Justice Roberts not participating) on whether section 16(b) "establishes a period of repose that is not subject to tolling."[35] The Court therefore did not decide that question.[36] The Court did, however, reject two rules for determining when section 16(b)'s two-year period begins.

Suing derivatively as a shareholder[37] in companies that went public in the 1990s and the year 2000, the plaintiff brought section 16(b) claims against underwriters in the initial public offerings ("IPOs"), as well as the insiders at the issuers.[38] She claimed that, in each IPO, the underwriters and issuer insiders acted together as a group, each group beneficially owned more than 10 percent of the common stock of each issuer, and members of each group engaged in purchases and sales in the "immediate aftermarket" of the IPOs.[39] The plaintiff filed her suits in October 2007—far more than two years after the purchases and sales on which the suits were based.[40]

Section 16(a) requires that the officers, directors, and more-than-ten-percent shareholders covered by section 16(b) file publicly available reports of transactions in the issuers' equity securities.[41] The Ninth Circuit had concluded that the

29. 15 U.S.C. § 78p(b) (2006 & Supp. V 2011).
30. *Id.*
31. *Id.*
32. 501 U.S. 350, 360 n.5 (1991).
33. *See* McCann v. Hy-Vee, Inc., 663 F.3d 926, 930 (7th Cir. 2011).
34. 132 S. Ct. 1414 (2012).
35. *Id.* at 1421.
36. *Id.*
37. Section 16(b) provides that a shareholder of an issuer having a section 16(b) claim can file a derivative case on behalf of the issuer if the shareholder requests the issuer to sue and the issuer fails or refuses to file within sixty days of that request. 15 U.S.C. § 78p(b) (2006 & Supp. V 2011).
38. *Credit Suisse*, 132 S. Ct. at 1418.
39. The case reached the Supreme Court after the district court granted a motion to dismiss and the Ninth Circuit reversed. *In re*: Section 16(b) Litig., 602 F. Supp. 2d 1202 (W.D. Wash. 2009), *rev'd sub nom.* Simmonds v. Credit Suisse Sec. (USA) LLC, 638 F.3d 1072 (9th Cir. 2011). The district court opinion provides the details in the text above. *Section 16(b) Lit.*, 602 F. Supp. 2d at 1207.
40. *Section 16(b) Lit.*, 602 F. Supp. 2d at 1206.
41. 15 U.S.C. § 78p(a) (2006 & Supp. V 2011).

plaintiff's suits were timely filed because the defendants had never filed section 16(a) reports on the purchases and sales and, therefore, the two-year period for section 16(b) suits had never begun.[42] Vacating that judgment,[43] the Supreme Court rejected the Ninth Circuit reasoning that the two-year period is "categorically tolled until [section 16(a) reports are] filed."[44] The Court found that such an interpretation would mean that "because [the defendants] have yet to file § 16(a) [reports] (as noted earlier they do not think themselves subject to that requirement), [the plaintiff] still has two years to bring suit, even though she is so well aware of her alleged cause of action that she has already sued."[45] That would be "especially at odds" with section 16(b) since it "imposes strict liability on putative insiders"[46]—liability without regard to mental state.[47]

The Court then considered a Second Circuit rule "that the 2-year period is tolled until the plaintiff 'gets actual notice that a person subject to Section 16(a) has realized specific short-swing profits that are worth pursuing.'"[48] Rejecting that protocol as well, Justice Scalia found that it "departs from the usual equitable-tolling principle[]"[49] "that when a limitations period is tolled because of fraudulent concealment of facts, the tolling ceases when those facts are, *or should have been*, discovered by the plaintiff."[50]

*Significance and analysis*. *Credit Suisse* fails to resolve the big question—whether the two-year period in section 16(b) is a statute of repose, never subject to tolling, or a statute of limitation, subject to equitable tolling. At least one treatise writer concludes that "[u]nless the Supreme Court revisits the issue, it appears that equitable tolling should be applicable to section 16(b) claims."[51] But that equitable tolling will be subject to the same rules as equitable tolling of other federal limitations periods. In particular, the tolling will not continue "beyond the point at which a § 16(b) plaintiff is aware, *or should have been aware*, of the facts underlying the claim."[52]

## Courts of Appeals

**Insider Trading**: *Second Circuit clarifies elements of tipper and tippee liability; information could be public even if known only to a few analysts or professional investors; information may be material if it specifically and reliably confirms a rumor already in circulation.*

42. *Simmonds*, 638 F.3d at 1096–97.
43. *Credit Suisse*, 132 S. Ct. at 1421.
44. *Id.* at 1420.
45. *Id.*
46. *Id.*
47. Section 16(b) does not include any mental state as an element of liability. 15 U.S.C. § 78p(b) (2006 & Supp. V 2011).
48. *Credit Suisse*, 132 S. Ct. at 1421 n.7.
49. *Id.*
50. *Id.* at 1420 (emphasis added) (citing 2 Calvin W. Corman, Limitations of Actions § 9.7.1, at 55–57 (1991)).
51. Thomas Lee Hazen, The Law of Securities Regulation § 13.2[4][D] (6th ed. Supp. July 2012).
52. *Credit Suisse*, 132 S. Ct. at 1420 (emphasis added).

Last year brought two significant insider trading decisions. The Second Circuit considered and helpfully elaborated the elements of tipper and tippee liability.[53] The Second Circuit also held that information can become public—and therefore trading on that information can proceed without insider trading violations—even though that information is not widely known and, in the same case, held that specific and reliable information may be material even though it only confirms more general media reports or rumors.[54]

*Elements of tipper and tippee liability*. In a case that reads like a law school exam, the Second Circuit last year addressed the elements of tipping and tipper liability. *SEC v. Obus* involved Allied Capital Corporation's ("Allied") acquisition of SunSource, Inc. ("SunSource").[55] Allied sought financing for the deal from GE Capital Corporation ("GE Capital").[56] Thomas Strickland, an assistant vice president and underwriter at GE Capital, performed due diligence on SunSource and learned of the deal through that work.[57] The SEC alleged that Strickland told Peter Black about the upcoming acquisition[58] and that Black—who worked as an analyst at a hedge fund manager called Wynnefield Captial, Inc. ("Wynnefield"), whose funds had traded in SunSource stock—passed this information on to his boss at Wynnefield, Nelson Obus.[59] About two weeks later, Obus caused Wynnefield to buy 287,200 SunSource shares.[60] Eleven days after that, Allied announced that it was buying SunSource. The price of SunSource stock rose by 100 percent, and Wynnefield's SunSource stock showed a $1.3 million unrealized profit.[61]

The SEC sued Strickland, Black, and Obus for insider trading in violation of Rule 10b-5.[62] After the district court granted summary judgment to the

53. *See infra* notes 55–87 and accompanying text.
54. *See infra* notes 88–104 and accompanying text.
55. 693 F.3d 276, 279 (2d Cir. 2012).
56. *Id.*
57. *Id.*
58. *Id.* at 280. Black and Strickland denied that Strickland had passed on this information. *Id.* The SEC argued that the subsequent events showed that Strickland had. *Id.* Among other things, the SunSource CEO testified that Obus called and said that Wynnefield, as the court put it, "had been tipped about SunSource's imminent acquisition." *Id.* at 281. The buyer's CFO also testified that Obus told the CFO "that Obus 'was tipped off to the deal.'" *Id.* at 282. In relying on these post-tip events that made sense only if the tip had occurred, the Second Circuit observed that "we have never held that a tip needs to be established by direct evidence (indeed, such a requirement would restrict successful tipping cases to those in which at least one party cooperated with the government, or where the government had a court-authorized surreptitious recording)." *Id.* at 290.
59. *Id.* at 280–81.
60. *Id.* at 282. The purchase occurred after a trader (who was not involved in the chain of tipping) contacted Wynnefield, offering to sell 50,000 SunSource shares for $5/share, and Wynnefield counteroffered. *Id.* The district court opinion states that "[u]ltimately, on June 8, 2001, Wynnefield's trader (Zelkowicz) purchased a block of 287,200 shares of SunSource stock at $4.80 per share, which were deposited into the accounts of Wynnefield Partners Small Cap Value L.P. . . . , Wynnefield Partners Small Cap Value L.P. I . . . , and Wynnefield Partners Small Cap Value Offshore Fund, Ltd." SEC v. Obus, No. 06 CIV 3150 (GBD), 2010 WL 3703846, at *6 (S.D.N.Y. Sept. 20, 2010). The SEC named those funds as relief defendants. *Id.* at *1.
61. *Obus*, 693 F.3d at 282.
62. *Id.* at 283.

defendants, the SEC appealed, relying on the misappropriation theory.[63] That theory "targets persons who are not corporate insiders but to whom material nonpublic information has been entrusted in confidence and who breach a fiduciary duty to the source of the information to gain personal profit in the securities market."[64] The Second Circuit vacated the defense judgment,[65] holding that the SEC had submitted evidence sufficient to raise material issues of fact as to all three defendants.[66]

Addressing the scienter element of the Rule 10b-5 claim, the court opened with the proposition that "[i]n every insider trading case, at the moment of tipping or trading, just as in securities fraud cases across the board, the unlawful actor must know or be reckless in not knowing that the conduct was deceptive."[67] Applying this principle, the court held that, for a tipper to have scienter, he or she (i) "must tip deliberately or recklessly, not through negligence"; (ii) "must know that the information that is the subject of the tip is non-public and is material for securities trading purposes, or act with reckless disregard of the nature of the information"; and (iii) "must know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty."[68] The court recognized that, as a separate element, the tipper must tip "for personal benefit."[69] Addressing the requisite expectation that the tippee will use the information to trade, the Second Circuit incorporated that expectation into its scienter analysis, holding that the question of whether the tip was deliberate or reckless (satisfying scienter)—as opposed to negligent (not satisfying scienter)—depended on whether the alleged tipper knew or was reckless in not knowing that there was a reasonable expectation that the recipient would use the information for trading.[70]

Turning to tippee scienter, the court recited the rule that the tippee is liable if he or she "'knows or should know that there has been a breach'" of a fiduciary duty by the tipper in conveying the material nonpublic information.[71] When tipping chains are involved:

> The first tippee must both know or have reason to know that the information was obtained and transmitted through a breach, and intentionally or recklessly tip the information further for her own benefit. The final tippee must both know or have reason to know that the information was obtained through a breach, and trade while in knowing possession of the information.[72]

63. *Id.* at 283–84.
64. *Id.* at 284.
65. *Id.* at 293.
66. *Id.* at 289.
67. *Id.* at 286.
68. *Id.*
69. *Id.*
70. *Id.* at 287.
71. *Id.* (quoting Dirks v. SEC, 463 U.S. 646, 660 (1983)) (emphasis omitted).
72. *Id.* at 288.

Moving with this doctrine to the case at hand, the Second Circuit found at least an issue of fact as to whether Strickland had scienter. Strickland owed a duty of confidentiality to GE Capital because he was GE Capital's agent and therefore was prohibited from using his principal's confidential information for his own benefit.[73] Strickland knew that the information about SunSource was confidential because every page of the deal book he was given for his work on SunSource "was marked 'Extremely Confidential.'"[74] And he knew that he had an obligation to refrain from passing such confidential information on to others because "Strickland had reviewed and annually signed GE Capital's employee code of conduct, which required employees to 'safeguard company property [including] confidential information about an upcoming deal.'"[75] Strickland also knew or was reckless in not knowing that Black would use the information about the SunSource deal for trading because "Strickland knew that Black worked for a hedge fund that traded in stocks (sufficient knowledge in itself) and, additionally, that Black's hedge fund traded in SunSource shares."[76] That evidence was sufficient to raise "a genuine issue of material fact" that "Strickland knew there was a high likelihood that the tip would result in the trading of securities."[77]

The Second Circuit also found that the SEC provided adequate evidence to raise a question that Strickland had tipped for personal benefit. The Supreme Court has held that the personal benefit element is satisfied if the tipper intended to make a gift by conveying the information.[78] The fact that "Strickland and Black were friends from college" was enough to raise a question whether Strickland passed the tip on "knowing that he was making a gift of information Black was likely to use for securities trading purposes."[79]

Turning to Black, the Second Circuit found that the SEC ultimately had to "establish that Black knew or should have known that Strickland breached a fiduciary duty when he passed along the tip."[80] The SEC had provided enough to raise a genuine issue on that element simply by showing that Black was a sophisticated participant in the financial world who would likely know that someone in

73. *Id.* at 289 ("Restatement (Third) of Agency § 8.05 (2006) ('An agent has a duty . . . not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party.'").

74. *Id.* at 279–80 (emphasis omitted), 289 (emphasis omitted).

75. *Id.* at 280, 289.

76. *Id.* at 290–91.

77. *Id.* at 291.

There was no question that information about the impending acquisition was both material and nonpublic. *Id.* at 289 n.3 ("Unannounced acquisitions are a prototypical example of material nonpublic information."). The opinion does not discuss whether Strickland knew or was reckless in not knowing that the information was material and nonpublic. Perhaps Strickland never contested that element.

78. *Id.* at 291 (citing Dirks v. SEC, 463 U.S. 646, 664 (1983)).

79. *Id.*

The district court had held that Strickland had to engage in some deception beyond tipping. *Id.* But, under the misappropriation theory, Strickland—by the tipping itself—"deceived and defrauded GE Capital," which "is all the deception that section 10(b) requires." *Id.*

80. *Id.* at 292.

Strickland's position would be prohibited from conveying information about an upcoming acquisition not yet public.[81] Because that evidence was sufficient to raise a triable issue that Black knew that Strickland should not have passed the information to him, it was sufficient to raise a triable issue that Black "inherited Strickland's" duty not to pass the information on further.[82] Black violated that duty by passing the information on to Obus, and "knew there was a reasonable expectation that Obus would trade in SunSource on Wynnefield's behalf while in possession of the tip" because Black knew that Wynnefield already had purchased some SunSource stock.[83] Moreover, the evidence raised a genuine issue of fact that Black had tipped Obus for personal benefit—"in order to curry favor with his boss."[84]

Analyzing Obus last, the court found sufficient evidence to raise a fact question that he knew or should have known that the SunSource information he received from Black was conveyed by a breach of duty because—*after* Obus told the SunSource CEO that he (Obus) had been tipped by someone at GE and *before* Obus directed the purchase of the 287,200 SunSource shares—Black told Obus that Obus's comment to the SunSource CEO was going to get Black's friend (Strickland) "'fired,'" thereby clearly implying to Obus that Strickland had breached a duty by providing the tip.[85] Finally, there was evidence that Obus "subjectively knew he possessed material non-public information when he made the [287,200 share] purchase"—as he told the SunSource CEO that he (Obus) had been tipped to SunSource's impending sale to a financial buyer and told the buyer's CFO the same thing—which raised sufficient factual questions as to the additional elements needed to establish tippee liability.[86]

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81. As the court wrote:

> Black, a sophisticated financial analyst, testified that he knew Strickland worked at GE Capital, which provided loans to businesses; that he knew Strickland was involved in developing financing packages for other companies and performing due diligence; and that information about a non-public acquisition would be material inside information that would preclude someone from buying stock. This is sufficient for the jury to conclude that Black knew or had reason to know that any tip from Strickland on SunSource's acquisition would breach Strickland's fiduciary duty to GE Capital.

*Id.*

82. *Id.* The duty was to "abstain or disclose," with the disclosure here being disclosure to Strickland's principal—GE Capital—because the essence of Strickland's deception was feigning loyalty to that principal while violating the duty of confidentiality. *Id.* at 285, 292 n.4.

83. *Id.* at 292.

84. *Id.* (noting that the requisite personal benefit can be a "reputational advantage").

85. *Id.* at 281, 293.

86. *Id.* at 281–82, 293. The court held that "knowing possession" of the material nonpublic information would be enough "whether or not [Obus's] purchase was directly caused by his knowledge of the pending acquisition." *Id.* at 293 (citing United States v. Teicher, 987 F.2d 112, 120–21 (2d Cir. 1993)). The SEC's rule, 17 C.F.R. 240.10b5-1(a) & (b) (2012), uses a similar standard—sufficient "if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale"—but the Second Circuit in *Obus* does not mention the SEC rule. Other circuits require that the purchaser "use" the material nonpublic information but rebuttably presume use from possession. *See* SEC v. Lipson, 278 F.3d 656, 660–61 (7th Cir. 2002); SEC v. Adler, 137 F.3d 1325, 1337–38 (11th Cir. 1998).

*Significance and analysis*. *Obus* is a breath of fresh air. It has been unclear whether the scienter element for insider trading and tipping prohibited by Rule 10b-5 requires that the defendant know that his or her conduct violates a duty.[87] *Obus* resolves the matter in favor of including knowledge or reckless disregard of such a duty as a necessary part of scienter. A potential problem with including such a requirement in the scienter element is that doing so implies that ignorance of the law (which imposes the duty) is an excuse. But since the purpose of the scienter requirement at the grossest level is to ensure that a violator acted as a bad person when he or she traded or tipped and since the bad acting here consists of violating a duty, it makes sense to require that, in order to prove scienter, the government or plaintiff must prove that the defendant or respondent knew, or was reckless in not knowing, that he or she should not have traded or tipped.

*When information becomes public; materiality of specific and reliable information confirming rumors or general reports in media*. As *Obus* recognized, an insider trading violation requires trading or tipping material, nonpublic information. In *United States v. Contorinis*, the Second Circuit considered when information falls into those categories.[88] The defendant co-managed a fund portfolio and received information from an investment banker in the Mergers and Acquisitions group at UBS.[89] The information related to the possible acquisition of the Albertsons grocery store chain.[90] As the continuing stream of information from the banker—coupled in some cases with stories in the financial media—indicated that prospects for the acquisition waxed and waned, the defendant caused the fund he managed to buy and sell Albertsons stock.[91] The fund made profits and avoided losses in the aggregate amount of $12.65 million on the various trades.[92]

In unsuccessfully appealing his conviction for insider trading,[93] the defendant questioned the trial court's instruction defining material, nonpublic information.[94] The Second Circuit recognized that "[i]n order to be nonpublic and material, information must be different from general discussions in the marketplace at the time," and that, therefore, information about even something as important as a merger "is not material unless it contains something beyond what already was known to the public from news articles, analyst reports, or otherwise, and the additional information likely would have been significant to a reasonable investor."[95] Thus, "[a] generalized confirmation of an event that is fairly obvious

87. *See* William K.S. Wang & Marc I. Steinberg, Insider Trading § 4.4.3, at 165 (2010) [hereinafter Wang/Steinberg Insider Trading] ("If liability is based on the misappropriation theory," it should be "necessary" that the "tipper or trader . . . know (or recklessly disregard the fact) that the tip or trade is a breach of duty to the information source"); *id.* at 165 n.322 (noting authority that seems to require this knowledge, or recklessness, and authority that does not).

88. 692 F.3d 136 (2d Cir. 2012).

89. *Id.* at 139.

90. *Id.* at 139–41.

91. *Id.* at 139.

92. *Id.* at 145.

93. *Id.* at 139 (nature of charge), 148 (conviction affirmed).

94. *Id.* at 141–44.

95. *Id.* at 143.

to investors knowledgeable about the company or the particular security at issue—here Albertsons or Albertsons stock—is not material information."[96]

Nevertheless, the trial court properly instructed the jury that "confirmation by an *insider* of unconfirmed facts or rumors—even if the unconfirmed facts or rumors had previously been reported in a newspaper—may itself be inside information."[97] The court reached this conclusion by reasoning that nonpublic information that "is sufficiently more detailed and/or reliable than publicly available information" may be "deemed significant, in and of itself, by reasonable investors."[98] The Second Circuit also endorsed the district court's instruction that information can be public if it is "available," as it is "deemed public if it is known" even by "only . . . a few securities analysts or professional investors" because "their trading will set a share price incorporating such information."[99]

*Significance and analysis*. In the mergers and acquisitions context, the Supreme Court has held that materiality "'will depend at any given time upon a balancing of both the indicated probability that the [deal] will occur and the anticipated magnitude of the [deal] in light of the totality of the company activity.'"[100] While the Second Circuit did not rely on this analysis in *Contorinis*, that construct applies quite nicely to the problem that the *Contorinis* court faced. A merger or other acquisition is a high-magnitude event for the target company, and therefore the materiality of information about a possible acquisition depends on the probability that the information implies. A vague rumor of acquisition from an unidentified source or an unreliable source raises a low probability of a takeover. Specific information consistent with the rumor or confirmation by a reliable source raises the probability considerably, and hence can be material.[101]

The Second Circuit discussion of when information becomes public is more problematic. The notion that information can be public for insider trading purposes even though known to only a few—provided that the few trade in a way that incorporates the information into securities prices—is one of two different criteria that can be used to identify the threshold for "public" information; the other criterion is widespread dissemination.[102] The *Contorinis* opinion employs the first criterion without citation to any authority,[103] even though one of the cases frequently cited to identify the time when information becomes public is a Second Circuit opinion that employs the second criterion.[104]

96. *Id.*

97. *Id.* (emphasis added).

98. *Id.* at 144.

99. *Id.*

100. Basic Inc. v. Levinson, 485 U.S. 224, 238 (1988) (quoting SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc)).

101. Of course, the specifics could go to the magnitude of the transaction as well. For example, if the rumor failed to identify a deal premium, if recent premiums in the target's industry were about 20 percent, and the confirmation specifically identified the premium in a particular deal as 40 percent, that confirmation would affect the magnitude in *Basic*'s probability/magnitude analysis.

102. *See* Wang/Steinberg Insider Trading, *supra* note 87, § 4.3, at 142–57.

103. *Contorinis*, 692 F.3d at 143.

104. *Texas Gulf Sulfur Co.*, 401 F.2d at 853–54.

**Section 16(b)**: *an equity transaction based upon a debt that has not matured is not within the "debt previously contracted" exemption from purchases or sales subject to short-swing profit recovery; exchange of one convertible debt for another debt with significantly different terms is a "purchase" for section 16(b) purposes; beneficial ownership, and hence disgorgement obligation, extended to individual who was managing member of an LLC that was the managing partner of a limited partnership that bought and sold the equity security subject to section 16(b) recapture; issuer board's approval of sale to more-than-ten-percent shareholder did not exempt sale from short-swing profit computations; limited partnership owning stock was subject to section 16(b) profit recapture despite delegation of investment decisions to individuals who were members of a limited liability company that was the general partner of the limited partnership.*

Just as the Supreme Court decided a section 16(b) case last year,[105] so the Second Circuit addressed that section. That court of appeals did so in three cases. The first extensively considered the exemption from section 16(b) computations of equity acquisitions in exchange for a "debt previously contracted."[106] Both that case[107] and a second one[108] raised the question of which entities and individuals are liable for section 16(b) disgorgement when a more-than-ten-percent shareholder buying and selling the covered security is a limited liability entity that is managed by another limited liability entity that is, in turn, managed by individuals. The second case also presented the question of whether an acquisition by a more-than-ten-percent shareholder is exempt from short-swing profit calculations if the issuer's board approves the acquisition.[109]

*Exemption for acquiring a security in exchange for a "debt previously contracted."* The defendants in *Analytical Surveys, Inc. v. Tonga Partners,* L.P.[110] included an individual, the limited liability company ("LLC") at which that individual was a managing member, and the limited partnership at which the LLC was the general partner.[111] The limited partnership loaned money to a publicly traded issuer, the stock of which was registered under section 12 of the Exchange Act.[112] The partnership first received a senior secured promissory note in 2002, convertible at any time before maturity into common stock, with a conversion price set at the lower of a fixed price and two floating prices, and with any outstanding balance on maturity automatically converting into common stock based upon the conversion price.[113] The 2002 note was linked to a registration rights agreement, and provided that a violation of that agreement constituted an event of default under the note.[114] In October 2003, the partnership converted some of the

105. *See supra* notes 29–52 and accompanying text.
106. *See infra* notes 110–49 and accompanying text, particularly at notes 110–45.
107. *See infra* notes 110–49 and accompanying text, particularly at notes 110–49.
108. *See infra* notes 150–73 and accompanying text, particularly at notes 165–73.
109. *See infra* notes 150–73 and accompanying text, particularly at notes 150–64.
110. 684 F.3d 36 (2d Cir. 2012), *cert. denied*, 133 S. Ct. 1805 (2013).
111. *Id.* at 39–40.
112. *Id.* at 40.
113. *Id.* at 40–41.
114. *Id.* at 41.

2002 note amount to common stock and, as a result, held more than 18 percent of the issuer's outstanding common.[115] The partnership received at that time an amended note with terms similar to those in the 2002 note.[116] The 2003 note fell into default in 2004 as a result of the issuer's failure to comply with the registration rights agreement.[117]

Upon that default, the partnership had three contractual remedies: (1) accelerate the entire unpaid principal under the 2003 note; (2) demand prepayment of at least 130 percent of the principal amount of that note; or (3) demand that the outstanding principal be converted into the issuer's common stock, with the amount of the common determined by application of the conversion pricing formula to the outstanding principal.[118] Instead of exercising any of these remedies, the partnership negotiated a new note—issued on June 30, 2004—that changed the terms governing events at the note's maturity.[119] While the 2003 note provided for *automatic* conversion of any outstanding principal at maturity to common stock, the 2004 note gave the partnership the *option* to *either* convert the outstanding principal to common *or* insist on payment in cash.[120]

The 2004 note maintained the right to convert at any time and, exercising that right, the partnership elected on November 10, 2004 to convert all of the debt into the issuer's common stock, which the partnership then sold between November 10 and November 15, 2004.[121] The issuer sued to recover short-swing profits under section 16(b), and the trial court granted summary judgment to the issuer.[122] In affirming,[123] the Second Circuit held that both the acquisition of the June 30, 2004 convertible note and the conversion under that note on November 10, 2004 were purchases of the issuer's common stock that could be matched—for section 16(b) purposes—with the sales of stock from November 10 to November 15, 2004.[124] The opinion addressed five issues.

First, the court rejected the partnership's argument that the acquisition of the 2004 note—and the exercise of conversion rights attached to it—could not constitute a "purchase" under section 16(b) because that statute excepts from countable transactions the acquisition of an equity security "in good faith in connection with a debt previously contracted."[125] The Second Circuit held that, in order for this "debt exception" to apply, the debt for which the equity security is substituted must have matured by the time the equity is substituted for that debt.[126] Here, the debt under the 2003 note—for which the partnership

115. *Id.* at 41 n.6.
116. *Id.* at 41.
117. *Id.*
118. *Id.* at 41–42.
119. *Id.*
120. *Id.* at 42.
121. *Id.*
122. *Id.*
123. *Id.* at 53.
124. *Id.*
125. *Id.* at 39 n.1 (quoting 15 U.S.C. § 78p(b)).
126. *Id.* at 43–44.

received the 2004 note providing the equity conversion rights it exercised in early November 2004—had not reached maturity and, while the partnership had the right to accelerate the 2003 note after the default on the registration rights obligation, the partnership did not do so. Therefore, "the [2003] Note's maturity date continued to be [the original] April 2, 2005 [maturity date], and the Note was not a matured debt in June 2004."[127]

Second, the appellate court ruled that the note transactions here did not fall within the special and limited category of deals that the Supreme Court recognized to lie outside of section 16(b) coverage in *Kern County Land Co. v. Occidental Petroleum Corp.*[128] A prerequisite for such "borderline" or "unorthodox"[129] transactions is that the stockholder engaging in the short-swing purchase/sale had no access to issuer inside information.[130] Since the partnership "[did] not contend that it lacked inside information," the partnership could not rely on the *Kern* case and its progeny to remove the transactions involving the notes from section 16(b)'s reach.[131]

Third, the court held that the acquisition of the 2004 note was a "purchase" for purposes of section 16(b) because the 2004 note materially changed the terms of the 2003 note it replaced.[132] In particular, the 2004 note extended the debt's maturity from April 2005 to January 2006 (at any time during which the partnership could convert debt into issuer common stock according to the note's conversion formula) and permitted the partnership to choose—at maturity—to *either* be paid the outstanding principal in cash *or* to convert that principal into the issuer's stock (whereas, under the 2003 note, the unpaid principal *automatically* converted to stock).[133] These changes were "material" for section 16(b) purposes because it gave the partnership "more time . . . within which to use inside information in determining whether (and when) to convert the Note into shares."[134]

127. *Id.* at 44–45.

128. *Id.* at 45–46 (citing Kern Cnty. Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593–94 & n.26 (1973)).

129. The Second Circuit called such deals "borderline transactions." They are also frequently described in section 16(b) patois as "unorthodox" transactions. 1 Louis Loss et al., Fundamentals of Securities Regulation 902 (6th ed. 2011) [hereinafter Loss, Fundamentals].

130. *Analytical Surveys*, 684 F.3d at 46.

131. *Id.* at 46.

132. *Id.* at 47–48.

133. *Id.* at 47; *see also id.* at 40 (original 2002 note included the right "at any time prior to the maturity date" to "convert part or all of the Note's principal (and accrued interest) into shares of [the issuer's] common stock"), 41 (2003 note was "issued . . . on the same terms as before"), 47 (describing only two differences between the 2003 and 2004 note—neither of which removed the partnership's right to convert debt into stock during the duration of the loan).

134. *Id.* at 47. The Second Circuit may be using the word "material" here to mean something different from "material," as securities practitioners ordinarily use that word. *See* 17 C.F.R. § 203.405 (2012) ("The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."). In *Analytical Surveys*, the court uses "material" to characterize a change in terms that significantly affects the opportunity to misuse inside information. That is, a change is "material," as *Analytical Surveys* uses that term, if it impacts the problem that section 16(b) is designed to avoid.

Accordingly, the 2004 note "constituted a newly-issued, rather than an amended security."[135]

Fourth, the Second Circuit held that both the June acquisition of the 2004 note and the November conversion of the note into issuer common stock were "purchases" of common stock for section 16(b) purposes.[136] Beginning with the general notion that "[f]or § 16(b) purposes, acquiring a derivative security that gives the holder the option to purchase shares at a fixed price or to convert into shares at a *fixed* price is treated as equivalent to purchasing the shares directly,"[137] the court noted that the "[r]ules are quite different, however, for options, convertible securities, and the like that allow the purchase of shares at a *floating* price."[138] For floating rate convertibles and options, the purchase occurs on conversion or exercise, when the price is fixed and the opportunity to lock in profit occurs.[139] The 2004 note provided for conversion at the lower of a fixed price and two floating prices.[140] The "acquisition of [such] a hybrid instrument," with both a fixed price and floating prices in its conversion price formula, "constitutes a § 16(b) purchase"—at the time the convertible instrument is bought—"of the minimum number of shares that could be acquired if exercise were at the fixed price," with the later conversion of the debt into *that* number of shares "*not* an additional purchase."[141] The conversion of the debt into more shares—i.e., beyond the number of shares into which the debt could have been converted at the fixed price on acquisition of the convertible debt instrument—"is a separate § 16 purchase."[142] Thus, when the partnership acquired the 2004 note on June 30, 2004, it *could have* immediately converted that debt—in whole—into 850,000 shares at the $2.00 fixed price and therefore "purchased" that number of shares, for section 16(b) purposes, on June 30, 2004.[143] When the partnership in fact converted all of the debt into shares on November 10, 2004, the partnership "purchased," for section 16(b) purposes, the additional shares (over and above the 850,000) that the partnership received as a result of that conversion at a floating rate.[144] Both of those purchases were within six months of the sale of all the shares between November 10 and November 15, 2004, and hence the short-swing profits on all of those purchases and sales were forfeit by the punitive calculation employed in section 16(b) cases.[145]

Fifth and finally, the Second Circuit held that the trial court properly imposed the disgorgement obligation on (i) the limited partnership that purchased and

135. *Analytical Surveys*, 684 F.3d at 47.
136. *Id.* at 48–51.
137. *Id.* at 48 (emphasis added).
138. *Id.* at 49.
139. *Id.*
140. *Id.* at 40 (describing the conversion pricing for the 2002 note), 41 (2003 note was "issued . . . on the same terms as before"), 47 (describing only two differences between the 2003 and 2004 note—neither of which affected the conversion pricing).
141. *Id.* at 50–51.
142. *Id.*
143. *Id.* at 51.
144. *Id.*
145. *Id.*

sold the stock, (ii) the limited liability company that was the general partner of that limited partnership, and (iii) the individual who was the managing member of that limited liability company.[146] Rejecting the defense argument that the individual—who held all of the "voting and investment power"—should be the only one liable because he "was the sole 'beneficial owner' of the securities purchased" and that his liability should be limited to his personal "pecuniary interest in the profits realized,"[147] the court employed an agency analysis to conclude that the organizational defendants were also properly ordered to pay:

> Defendants do not attempt to argue that [the individual] . . . somehow lacked authority to bind [the limited liability company] by his actions. [The limited liability company] is thus responsible for the actions of [the individual] as its agent, just as [the limited partnership] is responsible for the actions of [the limited liability company] (carried out here by [the individual]) as [the limited partnership's] agent. . . . [T]herefore, both [the limited liability company] and [the limited partnership] are "beneficial owners" for § 16(b) purposes, and therefore subject to disgorgement of the profits realized here by [the limited partnership].[148]

But, while the limited partnership was liable for the entire disgorgement, the limited liability company and the individual were jointly and severally liable only for "their respective pecuniary interests in [the] short-swing profits."[149]

*Significance and analysis*. *Analytical Surveys* dramatically demonstrates the complexity of determining when the holder of convertible securities acquires underlying equity in a "purchase" that can be matched with a sale under section 16(b). The decision suggests that a client that buys a security convertible into equity registered under section 12 of the Exchange Act should be carefully advised as to the relationship of that investment to other purchases or sales of that same equity. A client buying such a convertible should consult its lawyers not only when it acquires the convertible but also before any changes in the convertible and before any purchase or sale of the equity into which the convertible can be converted.

*Application of section 16(b) to acquisition approved by issuer board; relationship of liability to structure of entity owning security*. The Second Circuit's second section 16(b) case—*Huppe v. WCPS International Inc.*[150]—was simpler. Each of two limited partnerships (the "Funds") owned more than 10 percent of an issuer.[151] Each of the limited partnership agreements "provide[d] that 'the management, operation and control of the business of the Fund shall be vested completely and exclusively in [a] General Partner' who 'shall have the right, power and

146. *Analytical Surveys*, 684 F.3d at 42 (stating that the district court rendered a judgment holding the limited partnership liable for the full amount of the short-swing profits and the limited liability company and individual "jointly and severally liable for their respective pecuniary interests in those profits").
147. *Id.* at 51.
148. *Id.* at 52.
149. *Id.* at 52 n.24.
150. 670 F.3d 214 (2d Cir. 2012).
151. *Id.* at 216.

authority, on behalf of the Fund and in its name, to exercise all rights, powers and authority of a general partner under the laws of Delaware.'"[152] Each of the general partners (in one case a limited liability company and in the other case a limited partnership) was run by two individuals—Marxe and Greenhouse—who held "the exclusive power to make all investment and voting decisions on behalf of the general partners and, in turn, on behalf of the Funds."[153] At the instigation of the issuer and in a transaction approved by the issuer's board, the Funds bought issuer stock on April 11, 2006, in a PIPE (private investment in public equity) deal, at a price 7 percent below the current market price for the issuer's stock.[154]

The April 2006 purchase was within six months of sales, by the Funds, of the issuer's stock in the period from December 2005 to January 2006.[155] A shareholder of the issuer brought a derivative suit to recover short-swing profits,[156] and the Second Circuit affirmed a summary judgment for the plaintiff,[157] addressing in the process two significant issues. First, the court rejected the Funds' argument that the April 2006 purchase was exempt from section 16(b) computation because that transaction "was the product of direct negotiations between [the issuer] and the Funds and approved by [issuer's] board of directors."[158] The Funds contended that, because the deal was done with the issuer's board, the Funds could not have reaped the advantage of any inside information; any information about the issuer that the Funds had was also in the possession of the issuer and its board.[159]

The court responded that the PIPE sale was not an "unorthodox" transaction exempt from section 16(b) coverage.[160] Instead, the deal was one in which "the Funds gave [the issuer] a wholly volitional capital infusion and had access to inside information," and in which the Funds might have been able to exploit that information by using their presumed influence over the issuer resulting from their large equity ownership.[161] While the Funds pointed to Rule 16b-3, which exempts from short-swing computations board-approved transactions between an issuer and its officers and directors,[162] the court responded that that rule does not extend to transactions between issuers and more-than-ten-percent

152. *Id.*
153. *Id.*
154. *Id.* at 216–17 (noting at 216 that the April 2006 deal got started when the issuer "approached Marxe and Greenhouse to gauge their interest in a PIPE transaction").
155. *Id.* at 217.
156. *Id.*
157. *Id.* at 217, 222.
158. *Id.* at 218.
159. *Id.*
160. *Id.* at 219. See *supra* note 129 and accompanying text, which refer to "unorthodox" transactions.
161. *Id.* (noting that the SEC's "position that ten percent holders 'can be presumed to have access to inside information because they can influence or control the issuer as a result of their equity ownership.' Ownership Reports and Trading by Officers, Directors and Principal Stockholders, Exchange Act Release No. 34-28869, 56 Fed. Reg. 7242, 7244 (Feb. 21, 1991).").
162. 17 C.F.R. § 240.16b-3 (2012).

shareholders.[163] The reason, as the SEC has put it, is that, while officers and directors "owe fiduciary duties to a corporation" that might restrain them from causing an issuer to sell to or buy at a time or under terms providing an advantage to the officers and directors based on inside information, a shareholder is not subject to such fiduciary restraints.[164]

In its second holding of note, the court of appeals rejected the defense argument that, since the Funds had delegated all voting and investment decisions to their general partners which were in turn run by Marxe and Greenhouse, the Funds themselves "possessed merely an economic interest in the [the issuer's] shares" and therefore were not 10 percent holders for section 16(b) purposes at all.[165] This was similar to the defense argument in *Analytical Surveys, Inc. v. Tonga Partners, L.P.* that, when a limited partnership holds shares in an issuer, a section 16(b) action can only recapture short-swing profits from the limited partnership's general partner and the individual(s) running the general partner.[166] And the Second Circuit rejected the argument here on the same basis as in *Analytical Surveys*: it "cannot be squared with basic principles of agency law."[167] "Marxe and Greenhouse served as agents of the Funds' respective general partners" which were the agents of the limited partnerships, so that—by a chain of principal/agent relationships—actions by Marxe and Greenhouse bound the Funds.[168] The Funds were accordingly "beneficial owners" of the stock that Marxe and Greenhouse caused the Funds to buy, even though Marxe and Greenhouse could be beneficial owners of that stock as well.[169]

*Significance and analysis*. *Huppe* prompts two thoughts. First, while the issuer receives any recovery in a section 16(b) suit, any shareholder of the issuer can bring the suit "if the issuer shall fail or refuse to bring such suit within sixty days after request."[170] Moreover, once a shareholder brings such a suit, the issuer may be unable step into the shareholder's place, seize control, and dismiss the case on the basis that pursuing the action is not in the best interests of the corporation.[171] Consequently, a 10 percent shareholder who buys stock from an issuer at the issuer's request—as did the Funds in *Huppe*—cannot look to the issuer's discretion (or gratitude for an infusion of capital that the issuer perhaps desperately needed) to stop a section 16(b) action that rests in part on that stock sale. Instead, the shareholder must protect itself and consider section 16(b)

163. 670 F.3d 214, 219–20 (2d Cir. 2012).

164. *Id.* at 220 (citing and quoting Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 34-37260, 61 Fed. Reg. 30376, 30378 n.42 (June 14, 1996) (to be codified at 17 C.F.R. pts. 228, 229, 240 & 249) ("Such duties, which act as an independent constraint on self-dealing, may not extend to ten percent holders. The lack of other constraints argues against making new Rule 16b-3 available to ten percent holders.").

165. *Id.* at 221.

166. *See supra* notes 146–49 and accompanying text.

167. *Huppe*, 670 F.3d at 221.

168. *Id.*

169. *Id.* at 221–22 (citing PETER J. ROMEO & ALAN L. DYE, SECTION 16 TREATISE AND REPORTING GUIDE § 2.03[5][f], at 134–35 (3d ed. 2008)).

170. 15 U.S.C. § 78p(b) (2006 & Supp. V 2011).

171. Burks v. Lasker, 441 U.S. 471, 484 & n.13 (1979).

issues *whenever* it buys or sells stock in a publicly traded company in which it holds more than 10 percent of a class of equity securities—even when the transaction is at the request of an issuer board on which the shareholder has no representative.

Second, *Analytical Surveys* and *Huppe* demonstrate together that an entity that meets the more-than-ten-percent ownership test of section 16(b) will be subject to short-swing profit recapture and cannot escape that result by delegating investment and voting decisions to managers. That makes sense, or else entity shareholders could structure their business to avoid section 16(b) routinely.[172] Moreover, the managers may be jointly responsible for at least a portion of those profits as well, even if they provide management services through limited liability entities.[173]

**Disclosure of Product Quality Problems and Government Inspection Reports**: *developing product quality control problems can constitute a "known uncertainty" requiring disclosure under Item 303; pharmaceutical company cannot represent that it is in material compliance with regulatory requirements without disclosing Form 483s if those inspection reports state that the company is violating FDA rules and current Good Manufacturing Practices and the number, severity, and pervasiveness of those violations would significantly alter the total mix of information for a reasonable investor*.

When product quality problems surface or government inspectors report violations, companies may agonize over whether the securities laws require disclosure even before the problems or reports produce economically significant consequences. In 2012, the Second Circuit held that a plaintiff adequately alleged a violation of Regulation S-K's Item 303 by pleading that an issuer failed to disclose in a registration statement quality problems with computer chips the issuer sold to its two most significant customers because—even before the issuer had determined the percentage of the chips it would need to replace—the problem could have created a "known uncertainty" within the meaning of that Item.[174] The Eighth Circuit held that a plaintiff adequately alleged false or misleading statements when it pled that a pharmaceutical company stated in Form 10-Ks that it complied with FDA regulations and FDA-approved manufacturing practices without simultaneously disclosing that the FDA was reporting continuing, serious manufacturing violations on Form 483s.[175]

*Duty to disclose quality control problems under Item 303*. Item 303(a)(3)(ii) of Regulation S-K requires that a company "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have

172. *Huppe*, 670 F.3d at 222.

173. In *Analytical Surveys*, the limited partnership was responsible for the entire short-swing profit ($4,965,898.95), while the limited liability company that was the limited partnership's general partner—and the individual who was the managing member of the limited liability company—were "jointly and severally liable for their respective pecuniary interests in those profits"—$553,896.37 (limited liability company serving as the general partner of the limited partnership) and $553,342.47 (managing member of the limited liability company). 684 F.3d at 42, 52 n.24.

174. *See infra* notes 176–92 and accompanying text.

175. *See infra* notes 193–209 and accompanying text.

a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[176] The Second Circuit interpreted that requirement last year in *Panther Partners Inc. v. Ikanos Communications, Inc.*[177] Procedurally, the plaintiff appealed denial of its motion to file an amended complaint alleging that Ikanos Communications, Inc. ("Ikanos") violated sections 11[178] and 12(a)(2)[179] of the Securities Act because Ikanos violated the Item 303(a)(3)(ii) disclosure requirement during a March 2006 offering by failing to disclose quality control problems.[180]

Ikanos developed and sold semiconductor chip sets.[181] Seventy-two percent of Ikanos's 2005 revenue derived from chip sales to two companies—Sumitomo Electric and NEC, each of which incorporated the chips into products sold to NTT.[182] The proposed amended complaint alleged that Sumitomo and NEC reported to Ikanos, in January 2006, that Ikanos's VDLS Version Four chips had developed a problem that caused NTT networks to fail.[183] Plaintiff's proposed pleading further alleged that (i) the former Ikanos Director of Quality and Reliability believed "the defects 'were a substantial problem for [Ikanos] to resolve in order to appease Sumitomo Electric and NEC and to retain them as customers,'"; (ii) the problem was sufficiently serious that it was discussed by the Ikanos board; (iii) Ikanos sent personnel to Japan to discuss the problem with Sumitomo and NEC; and (iv) Ikanos could not, with certainty, determine which chip sets were defective.[184] Three months after the offering, Ikanos agreed that it would replace all of the VDLS Version Four chip sets it had sold to NEC and Sumitomo—not just those with observable defects—to be sure that the replacement caught all of the defective sets.[185] Ikanos subsequently reported a net quarterly loss, followed by reductions in projected sales and the resignations of both the chief executive officer and the board chair.[186] Its share price dropped.[187]

In vacating the judgment for the defense and ordering the district court to permit the plaintiff to file its amended complaint, the Second Circuit had "little difficulty concluding that Panther has adequately alleged that the disclosures concerning a problem of this magnitude were inadequate and failed to comply with

176. 17 C.F.R. § 229.303(a)(3)(ii) (2012).

177. 681 F.3d 114 (2d Cir. 2012).

178. 15 U.S.C. § 77*l* (2006).

179. *Id.* § 77m(a)(2).

180. *Panther Partners*, 681 F.3d at 114. In 2009, the Second Circuit had affirmed the district court's dismissal of a first amended complaint in the case, but vacated the trial court's denial of plaintiff's motion for reconsideration and for leave to replead, with the appellate court ordering that the district court "consider all possible amendments." Panther Partners Inc. v. Ikanos Commc'ns, Inc., 347 F. App'x 617, 622 (2d Cir. 2009). The trial court denied plaintiff's motion to file a second amended complaint, which led to the appeal here. *Panther Partners*, 681 F.3d at 119.

181. *Panther Partners*, 681 F.3d at 116.

182. *Id.*

183. *Id.*

184. *Id.* at 116–17.

185. *Id.* at 117.

186. *Id.*

187. *Id.*

Item 303."[188] The appellate court ruled that the question was not—as the district court had framed it—whether Ikanos knew before the March offering that the defect rate on the chips was "above average"—as "Item 303's disclosure obligations, like materiality under the federal securities laws' anti-fraud provisions, do not turn on restrictive mechanical or quantitative inquiries."[189] Instead, because the defects known at the time of the offering could have led (as they did) to recalling 100 percent of the chips delivered to the two customers from which Ikanos derived 72 percent of revenue and were being discussed by the Ikanos board, the problems with the chips were "'known uncertainties' [that] could materially impact revenues" and therefore should have been disclosed per Item 303.[190]

*Significance and analysis*. *Ikanos* raises a tricky problem. At least some products of virtually every industrial company will be defective. When a defect is first reported, the company may not know the extent of the problem and, in particular, may not know what proportion of already-shipped products the company may ultimately need to recall. Hence in many cases, even the initial indication that a product problem exists carries with it *some* probability of a massive recall. Surely, not every such possibility is a "known uncertainty" that must be reported under Item 303. The focus should be on whether, under the particular facts, the company—in the words of Item 303—"reasonably expects" the uncertainty "will have a material . . . unfavorable impact on net sales or revenues or income."[191] As the SEC put it in its 1989 release on Item 303, "[i]f management determines that [the trend or uncertainty] is not reasonably likely to occur, no disclosure is required."[192]

The court's concentration on the materiality of the uncertainty in *Panther Partners* took the focus off whether the issuer reasonably expected a material impact. The facts that (i) the Ikanos board considered the problem and (ii) Ikanos was flying personnel to Japan to discuss the problem may have been sufficient to suggest that the company could not rule out a reasonable likelihood of the worst outcome, but such likelihood analysis is essential for Item 303(a)(ii)'s application. *Ikanos* does not mean that any sign of product defect creates an Item 303 disclosure obligation.

*Duty to disclose 483s when representing compliance with FDA regulatory requirements*. The defendant in *Public Pension Fund Group v. KV Pharmaceutical Co*. was regulated by the FDA.[193] From June 2004 through June 2008, KV stated in its Form 10-Ks that "[w]e believe that all of our facilities are in material compliance with applicable regulatory requirements" and "that we are currently in material compliance with cGMP," the acronym for the FDA's current Good Manufacturing Practices.[194] The plaintiffs alleged that before, during, and

188. *Id*. at 122.
189. *Id*.
190. *Id*. at 121–22.
191. 17 C.F.R. § 229.303(a)(3)(ii) (2012).
192. Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6835, 43 SEC Docket 1330, 1335 (May 18, 1989).
193. 679 F.3d 972, 975–79 (8th Cir. 2012).
194. *Id*. at 976, 980.

after that period, the FDA repeatedly inspected KV facilities, found serious violations of FDA rules and cGMP, and reported those violations to KV on Form 483s[195]—documents that the agency uses to advise management of significant objectionable conditions found during FDA inspections of regulated operations.[196] In December 2008, KV suspended shipment of all the FDA-approved products it manufactured in tablet form, and the company completely shut down manufacturing the next month.[197] In February 2009, the FDA sued KV and affiliated entities and individuals, seeking a permanent injunction to stop KV from producing pharmaceutical products because of manufacturing irregularities.[198]

Investors sued KV and individuals working for it, alleging among other things that KV's statements that it believed itself to be in compliance with regulatory requirements and cGMP were knowingly false because the government had told KV, in the Form 483s, that it was not in compliance.[199] Reversing in part a district court order dismissing the case,[200] the Eighth Circuit rejected KV's argument "that the receipt of Form 483s can never render a company's statements about compliance with FDA regulations or cGMP false or misleading" because the forms only report FDA inspectors' observations and do not represent a final agency determination that a pharmaceutical company has committed violations.[201] The court held that, "irrespective of whether the Form 483 represents the FDA's final say on compliance issues," "[t]he issuance of a Form 483 represents a risk that the FDA may take corrective action against a company, and thus a company is obligated to assess the seriousness of the risk and [subject to the materiality of that risk] disclose such information to potential investors if it also represents it is in compliance with FDA regulations and cGMP."[202] The risk of FDA sanctions and required remedial action—implied by a Form 483—"may be material depending on a number of factors, including the number, severity, and pervasiveness of objectionable conditions noted [in the form], as well as whether a company has failed to address or correct the deficiencies noted by the FDA."[203]

Here the information about the Form 483s was sufficiently pled to allege that the statements of compliance were misleading because, according to the complaint, the forms showed "a lengthy history of KV manufacturing adulterated, unapproved, and misbranded drugs in violation of FDA regulations due to

195. *Id.* at 976–77. The plaintiffs further alleged that KV committed at least one FDA violation that the FDA did not find because KV concealed it. *Id.* at 978.

196. *Id.* at 976 ("Form 483s are issued pursuant to FDA regulations to notify a company's 'top management in writing of significant objectionable conditions, relating to products and/or processes, or other violations of the [FDA] which were observed during the inspection' of a facility. FDA Investigations Operations Manual, Ch. 5, § 5.2.3 (2009).").

197. *Id.* at 979.

198. *Id.* at 976.

199. *Id.* at 979–80.

200. *Id.* at 975, 990.

201. *Id.* at 981.

202. *Id.* at 982.

203. *Id.* at 983.

manufacturing irregularities," including "KV's failure to manufacture pharmaceutical products with the correct proportion of ingredients, and the correct tablet sizes," and its "fail[ure] to address or correct serious manufacturing problems."[204] This satisfied the test for materiality, which is whether "[t]here is a substantial likelihood the presence of these factors would be viewed by a reasonable investor as significantly altering the total mix of information made available."[205]

Turning to the duty to disclose the information in the Form 483s, the court of appeals noted that KV had gone beyond "indicat[ing] that it was regulated by the FDA" and "affirmatively represented it was compliant with FDA regulations."[206] That affirmative representation, in turn, gave "rise to a duty to disclose material information" to the contrary.[207]

*Significance and analysis*. The *KV* opinion is hard reading for medical drug and device manufacturers. The FDA inspects frequently and may find plenty on which to comment. But even if Form 483s contain adverse comments, it is still possible for a life sciences company to believe itself in "material" compliance with FDA regulations and cGMP in the sense that the adverse comments on the Form 483s imply only a low risk that the FDA will take action that will significantly affect company operations or performance. The key to determining whether Form 483s are material in a securities law sense and whether general statements about regulatory compliance are therefore misleading without disclosing the Form 483s (or information about them) is, as the *KV* opinion states, "the seriousness of the risk" that the Form 483s imply.[208]

In the mergers context, courts employ a probability/magnitude analysis to determine the materiality of early merger discussions—with the materiality of any given information determined by that information's marginal contribution to assessments of (i) the probability of a merger and (ii) the magnitude of the merger. That same analysis can structure the evaluation of the risk implied by a Form 483.[209] The pharmaceutical company can—based on its history with the FDA

204. *Id.*

205. *Id.*

206. *Id.* at 983 n.8.

207. *Id.* The Eighth Circuit, however, rejected the plaintiff's argument that a duty to disclose the Form 483s arose from KV's reports of financial results. *Id.* at 977–79, 984–85. The court ruled:

> KV only reported past financial performance. The financial statements did not discuss compliance with FDA regulations, or tie KV's financial performance directly to manufacturing processes. As a result, KV's statements did not trigger a duty to disclose its compliance with FDA regulations, or to discuss its manufacturing problems with [the drug the plaintiffs highlighted]. While Rule 10b-5 requires "an actor to provide complete and non-misleading information with respect to the subjects on which he undertakes to speak . . . the requirement is not to dump all known information with every public announcement[.]" *Id.* (citation omitted) (internal quotation marks omitted).

*Id.* at 984 (quoting *In re* K-tel Int'l, Inc. Sec. Litig., 300 F.3d 881, 898 (8th Cir. 2002)).

208. *Id.* at 982.

209. *See* William O. Fisher, *Key Disclosure Issues for Life Sciences Companies: FDA Product Approval, Clinical Test Results, and Government Inspections*, 8 MICH. TELECOMM. & TECH. L. REV. 115, 177–86 (2002) [hereinafter Fisher, *Key Disclosure Issues for Life Sciences Companies*].

and its knowledge of how the agency has treated other similar companies—assess both the possible consequences of the observations in the Form 483 (cost of remedial action, production delays, product recalls, amount of sanctions) and the probability of those outcomes. Obviously, those assessments can change over time. At any given time, however, the materiality of a Form 483, or series of such forms, will depend on (i) the likelihood of sanctions, corrective actions, and manufacturing stoppages; and (ii) the degree to which those adverse developments would affect the overall financial health and performance of the company.[210]

**Disclosure of Clinical Trial Results**: *published conclusions following the analysis of clinical trial results by one statistical technique are not false or misleading simply because application of a different statistical technique would have yielded different conclusions; press releases and conference calls announcing test results are not false or misleading simply because they omit details from the test results or fail to disaggregate test results in ways that some investors might desire*.

A pharmaceutical company reporting clinical trial results faces difficult choices, including what to include and what to leave out of summaries of those results in press releases and conference calls.[211] The Ninth Circuit addressed those choices last year in *In re Rigel Pharmaceuticals, Inc. Securities Litigation*.[212]

Rigel developed a drug designated R788 to treat rheumatoid arthritis.[213] Following Phase IIa tests, Rigel issued a press release on December 13, 2007, stating that R788 showed statistically significant positive results, when administered in 100 and 150 milligram doses twice daily over a twelve-week period—with the drug beating a placebo in reported 20, 50, and 70 percent improvements.[214] The release showed the number of patients in the trial—broken down by cohorts determined by whether they received the placebo, 50 milligram R788 doses, 100 milligram R788 doses, or 150 milligram R788 doses—and reported, for each cohort, the numbers of patients experiencing 20, 50, and 70 percent improvements.[215] The press release also reported "key safety results," which showed numbers of patients (i) who suffered diarrhea, gastritis, nausea, or dyspepsia of "moderate or greater" "severity," (ii) who suffered neutropenia that required dose reduction, or (iii) who experienced more than a specified elevation of liver enzymes.[216] The clinical trial had been conducted both in Mexico and the United States, and the press release reported aggregate results, without subdividing the numbers by country.[217]

210. For another decision involving Form 483s, see Plumbers & Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc., 679 F.3d 952, 953 (7th Cir. 2012) (summarized at *infra* notes 384–97 and accompanying text, particularly at notes 391–97).

211. Fisher, *Key Disclosure Issues for Life Sciences Companies*, *supra* note 209, at 142–65.

212. 697 F.3d 869 (9th Cir. 2012).

213. *Id.* at 871.

214. *Id.* at 872.

215. *Id.*

216. *Id.* at 872–73.

217. *Id.* at 871–72.

In 2008, doctors affiliated with the company made a presentation at a scientific meeting disclosing "much higher" response rates—for both the placebo and the R788 doses—among clinical trial participants in Mexico in comparison with participants in the United States.[218] They then published an article that included more information about side effects, including numbers of patients who had suffered mild diarrhea, neutropenias that did not require dose reduction, and elevation of liver enzymes below the floor used in the December 13, 2007 press release.[219]

An investor sued Rigel and individual defendants, charging violations of Rule 10b-5 and section 11.[220] The plaintiff "did not allege that Defendants inaccurately reported the results of their own statistical analysis" but contended that all the statements about R788's efficacy were false because the clinical trial results, when analyzed with a different statistical method, showed that the positive results from administration of the drug were not statistically significant.[221] The Ninth Circuit agreed with district court authority "that merely alleging . . . defendants should have used different statistical methodology in their drug trials is not sufficient to allege falsity."[222] To plead falsity requires "a plaintiff [to] set forth facts explaining why the difference between two statements 'is not merely the difference between two permissible judgments, but rather the result of a falsehood.'"[223] Here the "allegations . . . concern[ed] two different judgments about the appropriate statistical methodology to be used,"[224] did not

218. *Id.* at 874. Drs. Weinblatt and Grossbard made this presentation. *Id.* Grossbard was "senior vice president of medical development at Rigel." *In re* Rigel Pharms., Inc. Sec. Litig., No. C 09-00546 JSW, 2010 WL 8816155, at *2 (N.D. Cal. Aug. 24, 2010).

219. *Rigel*, 697 F.3d at 875. The article was authored by, among others, Michael E. Weinblatt, who received money from Rigel. Michael E. Weinblatt et al., *Treatment of Rheumatoid Arthritis with a Syk Kinase Inhibitor: A Twelve-Week, Randomized, Placebo-Controlled Trial*, 58 ARTHRITIS & RHEUMATISM 3309, 3309 n.1 (2008).

220. *Rigel*, 697 F.3d at 871. The section 11 case rested on a registration statement that allegedly incorporated the press release. *Id.* at 872 n.4. The plaintiff also alleged a violation of section 12(a)(2), but failed to pursue that claim on appeal. *Id.* at 871 n.1.

221. Here are the details of the plaintiff's position, as summarized by the court:

> Plaintiff challenged Defendants' reported statistical results by alleging that Defendants should have used Plaintiff's chosen statistical methodology, including calculating separate p-values for the United States and Mexico and combining those results using "Fisher's method," and using "Tukey's Studentized Range test." Plaintiff alleged that using its proposed statistical methodology would result in different p-values for the 100 mg and 150 mg doses . . . [showing 20 percent improvement] and that these newly calculated p-values were not statistically significant.
>
> Thus, Plaintiff's allegations of "falsity" essentially are disagreements with the statistical methodology adopted by the doctors and scientists who designed and conducted the study, wrote the journal article, and selected the article for publication. The allegations therefore concern two different judgments about the appropriate statistical methodology to be used by Defendants. The allegations are not about false statements.

*Id.* at 877–78.

222. *Id.* at 878 (citing Padnes v. Scios Nova Inc., No. C 95-1693, 1996 WL 539711 (N.D. Cal. Sept. 18, 1996)).

223. *Id.* at 877 (quoting *In re* GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1549 (9th Cir. 1994) (en banc)).

224. *Id.* at 878.

charge "that Defendants misrepresented their own statistical methodology, analysis, and conclusions," and therefore "did not adequately plead falsity with respect to statistic[al] results."[225]

The Ninth Circuit also rejected the plaintiff's contention that the 2007 press release and conference call provided false or misleading information "because the combination of data from the two countries concealed the existence of a country interaction."[226] The court held instead that

> to the extent Plaintiff suggests that parties conducting clinical trials necessarily are required to release all the detailed data or break that data down by categories that may plausibly be of interest to some investors, Plaintiff is incorrect. Section 10(b) and Rule 10b–5 do not categorically prohibit statements that are incomplete or that report cumulative figures instead of detailed breakdowns of the underlying data or subcategories of data.[227]

The court similarly spurned the plaintiff's allegations that Rigel's 2007 press release provided false or misleading information on side effects because the "[d]efendants should have reported more information related to blood pressure or liver enzyme levels."[228] The court noted that Rigel had "clearly identified its table of results for certain side effects as '*key* safety results,' not 'all safety results' or even just 'safety results.'"[229] Since the "[d]efendants never claimed that these were all of the safety results or that these results included every occurrence of every possible side effect," and specifically stated that they were only reporting certain side effects where they manifested in "moderate or greater" "severity," "the allegedly omitted information," which was simply "more detailed and extensive than the alleged original statements, . . . [and] did not contradict, or render misleading, the original reports of the top-line results."[230] The court added that "even if some investors might have wanted more extensive information related to blood pressure, liver

225. *Id.* at 879. Along the way, the court summarized "persuasive" reasoning from other cases in these words:

> Because there are many ways to statistically analyze data, it is necessary to choose the statistical methodology before seeing the data that is collected during the clinical trial; otherwise someone can manipulate the unblinded data to obtain a favorable result. Thus, the principal features of the statistical analysis usually are included in the protocol and the statistical analysis plan is finalized before the data is unblinded.

*Id.* at 878 (citation omitted).

> [T]the securities laws do not require that companies report information only from optimal studies, even assuming that scientists could agree on what is optimal, and . . . companies reporting information from imperfect studies are not required to disclose alternative methods for interpreting the data.

*Id.* at 879 (citation omitted).

226. *Id.* at 879–80.

227. *Id.* at 879 n.7 (citations omitted).

228. *Id.* at 880.

229. *Id.*

230. *Id.* at 880–81 & n.10.

enzymes, or other matters, that would not be sufficient to make the alleged original statements false or misleading."[231]

*Significance and analysis*. *Rigel* is critically important. Different biostatisticians may analyze clinical tests differently and reach different conclusions as to a drug's efficacy.[232] Use of one statistical method, which shows efficacy, is not misleading even if another method does not. As long as the company employs a statistical technique that is within a range of reasonableness and candidly identifies that technique, the conclusions from use of the technique should be neither false nor misleading under the securities laws.[233]

Just as life sciences companies will not report clinical test results analyzed by all possible statistical techniques, a company will not—in a press release and conference call—report those results in complete detail. Indeed, it will be impossible as a practical matter in those press releases and calls to provide every result from the tests, or to break down the results in every conceivable way. *Rigel* recognizes that "omissions" of some details are therefore sure to occur and the court rules, sensibly and in line with the law, that such omissions do not *per se* render the press release or conference call false or misleading. While an omission can mislead if the summaries provide a false impression without the undisclosed information,[234] careful articulation of the results selected for disclosure (e.g., by identifying them as "key" safety numbers, further elaborated as limited to side effects of moderate or greater severity or liver function elevation over an identified level) can decrease the probability that the press release or conference call will violate the securities law.[235]

**Criminal Cases**: *mail and wire fraud authorities used to interpret 18 U.S.C. § 1348; where fraud in § 1348 prosecution rests on misusing employer's confidential information, court must instruct on factors to consider in determining whether information was confidential, which may be different from factors determining whether information constituted trade secrets*; *government cannot prove materiality by using*

231. *Id.* at 881 (footnote omitted). The court also rejected a claim that the defendants misled by statements that a strategic partnership was "on track," *id.* at 881–82, and held that the complaint did not adequately plead the defendants' scienter, *id.* at 882–85.

232. Fisher, *Key Disclosure Issues for Life Sciences Companies*, *supra* note 209, at 143.

233. *Id.* at 143–45 ("Interpretation of test results is, to a significant degree, an art as well as a science. There may exist a range of reasonable interpretations. In a given case, the life sciences company may be sincerely committed to one interpretation within that range, which shows product efficacy, while the FDA might select another interpretation within that range, which shows that the drug is not effective or at least that the particular test results do not prove efficacy. Even within a company, different individuals, or even the same researchers and evaluators at different times, may reach different conclusions from the same test data. . . . Critically, if a company's positive interpretation of clinical tests is within the range of reasonable science, courts should not find the interpretation 'false' within the meaning of the securities laws.").

234. Rule 10b-5 prohibits "omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b) (2012).

235. *See* Fisher, *Key Disclosure Issues for Life Sciences Companies*, *supra* note 209, at 150 ("If it is within the range of reasonable medical, health care, and statistical science to conclude that one aspect of test results is important independent of other aspects, then reporting that one aspect without the others should impose no securities liability.").

*graphics to show simple stock price decline where decline occurred during revelation of problems other than the asserted fraud; conscious avoidance instruction can apply to knowledge of counterparty's future accounting for transaction; attorney could not defend fraud on the ground that he sought ethical guidance from a superior where the communication with the superior simply reported facts about a transaction.*

Two 2012 decisions in criminal cases included holdings important to securities practitioners. In the first decision, the Second Circuit provided an extensive discussion of the securities crime added by Sarbanes-Oxley and, in the same case, addressed both the definition of "confidential information" for purposes of mail or wire fraud by deprivation of honest services and the extent of forfeiture that can be imposed on an individual defendant in a securities case.[236] In the second decision, the same court considered the prosecution's use of graphics to prove stock price drops relevant to materiality, the propriety of a conscious avoidance instruction where the avoided knowledge was the future action of a contractual counterparty, and the possibility that a lawyer might obtain an instruction that he was absolved of fraud by consulting with a superior lawyer on ethical matters raised by the transaction involved in the case.[237]

*Wire and mail fraud authorities inform interpretation of 18 U.S.C. § 1348; whether information is confidential so that employees deprive their employer of honest services by transmitting the information to outsiders is a different question than whether the information constitutes a trade secret.* The defendants in *United States v. Mahaffy* worked as brokers at firms that used so-called "squawk boxes" to broadcast client orders aurally through speakers to traders, so that the traders could find buyers or sellers to take the other side of the squawked orders.[238] The government charged that the defendants placed phone receivers on their squawk boxes to transmit, in real time, the squawked orders to a day-trading firm, where traders there attempted to "front-run" those orders by "buy[ing] or sell[ing] shares at a more attractive price than would have been available once the squawked customer orders were executed."[239] The government alleged that, in exchange for providing the squawked information, the defendants received commissions on wash trades that traders at the day trading firm placed at the defendants' brokerage houses.[240] The government also charged that one defendant received a $500 cash payment from a day trader.[241]

After a first trial in which the jury acquitted the defendants on thirty-eight of thirty-nine counts and hung on a conspiracy count, the government retried the defendants on one count of conspiracy to commit securities fraud under 18 U.S.C. §§ 1348 and 1349 on two theories: (1) that the Broker Defendants deprived their employer firms of their honest services ("honest services fraud") under 18 U.S.C. § 1346 . . . ; and (2) that, when they transmitted squawks directly to [the day

236. *See infra* notes 238–61 and accompanying text.
237. *See infra* notes 262–81 and accompanying text.
238. 693 F.3d 113, 119–20 (2d Cir. 2012).
239. *Id.* at 120.
240. *Id.*
241. *Id.*

trading firm], the Broker Defendants deprived their employer firms of confidential information, which qualified as property ("property fraud") under *Carpenter v. United States*.[242]

This formulation of the charged offense was important. Congress added §§ 1348 and 1349 to the criminal code through the Sarbanes-Oxley Act.[243] Section 1348 provides:

> Whoever knowingly executes, or attempts to execute, a scheme or artifice—
>
> (1) to defraud any person in connection with . . . any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)); or
>
> (2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of . . . any security of [such] an issuer . . . ;
>
> shall be fined under this title, or imprisoned not more than 25 years, or both.[244]

Section 1349 then provides that "[a]ny person who attempts or conspires to commit any offense under this chapter shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy."[245] Section 1346—which was added to place deprivation of honest services within the reach of the mail and wire fraud statutes,[246] each of which outlaws "any scheme or artifice to defraud"[247]—defines "'scheme or artifice to defraud' [to] include[] a scheme or artifice to deprive another of the intangible right of honest services."[248] The U.S. Supreme Court decided *United States v. Carpenter* under the mail and wire fraud statutes.[249]

Thus, in *Mahaffy*, the government proceeded on the theory that fraud—for purposes of § 1348—is properly fleshed out by the authorities that elaborate "scheme or artifice to defraud" under the mail and wire fraud statutes.[250] So did the Second Circuit, which cited *Carpenter* for the proposition that, in order "to secure convictions under its property fraud theory, [the government]

242. *Id.* at 121 (citing Carpenter v. United States, 484 U.S. 19 (1987)).

243. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 807(a), 902(a), 116 Stat. 745, 804–05 (codified at 18 U.S.C. §§ 1348–49 (2006 & Supp. V 2011) [hereinafter SOX].

244. 18 U.S.C. § 1348 (2006 & Supp. V 2011).

245. 18 U.S.C. § 1349 (2006).

246. *See* Comm. on Fed. Regulation of Sec., *Caselaw Developments 2010*, 66 Bus. Law. 785, 799 (2011).

247. 18 U.S.C. § 1341 (2006 & Supp. V 2011) (mail fraud); *id.* § 1343 (wire fraud).

248. *Id.* § 1346.

249. 484 U.S. 19, 25–28 (1987).

250. The Second Circuit cited, with approval, to *U.S. v. Motz*, 652 F. Supp. 2d 284, 294 (E.D.N.Y. 2009), for the proposition that the "elements of securities fraud under § 1348(1) [are] (1) fraudulent intent, (2) scheme or artifice to defraud, and (3) nexus with a security." *Mahaffy*, 693 F.3d at 125. In turn, the district court deciding *Motz* said: "The parties agree that because 'the text and legislative history of 18 U.S.C. § 1348 clearly establish that it was modeled on the mail and wire fraud statutes,' the Court's analysis should be guided by the caselaw construing those statutes." *Motz*, 652 F. Supp. 2d at 296 (citation omitted).

had to prove beyond a reasonable doubt that the brokerage firms had exclusive use of the squawked information, considered that information to be confidential, and that they treated it as such."[251]

The Second Circuit vacated the broker convictions in *Mahaffy*[252] in part because of a government failure to provide the defense with transcripts of depositions taken by the SEC, in which witnesses from the brokerage houses at which the *Mahaffy* defendants worked testified that information broadcast through squawk boxes was not confidential.[253] But—aside from confirming that courts properly interpret §1348 by reference to wire and mail fraud authorities as set out above—the Second Circuit's decision contains two holdings of note. First, the appellate court found that the trial court did not err in refusing a proffered defense instruction to define "confidential business information" by reference to a series of factors used to define trade secrets.[254] The court of appeals held that "[i]nformation may qualify as confidential under *Carpenter* even if it does not constitute a trade secret."[255] But the court also advised that, if the case were retried, an "instruction regarding confidential business information should provide more fulsome guidance to assist the jury in determining whether the squawked information was confidential."[256] The Second Circuit elaborated:

> The pertinent factors will, of course, vary from case to case, but may include written company policies, employee training, measures the employer has taken to guard the information's secrecy, the extent to which the information is known outside the employer's place of business, and the ways in which other employees may access and use the information. If employers "consider" information to be confidential but do not really take affirmative steps to treat it as such and maintain exclusivity, *Carpenter* is not satisfied.[257]

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251. *Mahaffy*, 693 F.3d at 127.
252. *Id.* at 138.
253. *Id.* at 127–35. The "prosecutions were products of close collaboration between the United States Attorney's Office and the SEC," *id.* at 122, and both the prosecutors for the first *Mahaffy* trial and the prosecutors for the second trial were aware of the SEC transcripts, *id.* at 122–23. The prosecution owed the transcripts to the defendants under *Brady v. Maryland*, 373 U.S. 83 (1963).
254. *Mahaffy*, 693 F.3d at 134 (text of charge that court characterized as, "in large part, based on case law concerning civil trade secret claims").
255. *Id.* at 135.
256. *Id.* The trial court had charged:

> Confidential information acquired by a company in the operation of its business is a form of property, to which the company has the exclusive right and benefit.
>
> . . . .
>
> The law prohibiting people from scheming to defraud a company of its property recognizes confidential business information as a type of property and that the company has the exclusive—has the right, rather, to the exclusive use of the information. . . . Even if it lacks commercial value to the company, company policy may be to treat the information as confidential to protect the reputation of the company and its customers. What is key is that the company treat the information as confidential and with knowledge of that fact, its employee nonetheless knowingly discloses that information for an improper use.

*Id.* at 134–35.
257. *Id.* at 135 n.14.

*Significance and analysis*. *Mahaffy* is the first circuit court case to treat with 18 U.S.C. § 1348. The Second Circuit's citation to a lower court decision for the proposition that the elements of a § 1348 violation are "(1) fraudulent intent, (2) scheme or artifice to defraud, and (3) nexus with a security" is therefore important.[258] So is the Second Circuit's extensive treatment of the second element as one to be interpreted in light of authorities under the mail and wire fraud statutes.

The court's concern over the definition of "confidential" information is also interesting, because section 1348 could conceivably be used to prosecute insider trading violations. If such cases are brought under Rule 10b-5 and section 32(a) of the Exchange Act,[259] then the relevant question as to the status of the information is whether it was nonpublic, an element that has generated its own jurisprudence.[260] But if such cases are brought under § 1348 for the defendant's deprivation of an employer's exclusive use of "confidential" information, the case will turn (as to the status of the information) on whether the information is "confidential." There could be a difference if a court drew the public/nonpublic line at the point after widespread dissemination when the market could reasonably be expected to have absorbed the information. Such a court might find the information not yet public even after release rendered the information no longer "confidential."[261]

*Use of graphics to prove materiality by stock price drop improper where drop occurred during revelation of bad news unrelated to the charged fraud; conscious avoidance instruction applied to knowledge of contractual counterparty's future accounting for transaction; lawyer defense based on ethical consultation with attorney's superior*. Last year, the Second Circuit in *U.S v. Ferguson*[262] vacated the convictions of General Re executives and a General Re lawyer for conspiracy, mail fraud, securities fraud, and false statements to the SEC—all growing out of a contract by which AIG sold reinsurance to General Re.[263] Three holdings deserve notice. First, the government introduced graphics showing AIG stock price declines as news about the reinsurance contract came out[264] and, while introducing

258. *See supra* note 250.
259. 15 U.S.C. § 78ff(a) (2006).
260. *See supra* note 102 and accompanying text.
261. *See supra* note 102 and accompanying text.
262. 676 F.3d 260 (2d Cir. 2011).
263. *Id.* at 267 (listing the charges on which defendants were convicted), 268 (noting that although AIG typically bought reinsurance from General Re, in this instance it acted as the reinsurer), 269 n.2 (identifying defendants), 294 (vacating the convictions). For AIG to account legitimately for the deal as reinsurance, the transaction had to transfer risk from General Re to AIG. *Id.* at 268–69. The transaction did not do so. The contract required AIG to pay—on losses for insurance of $600 million in risk—only the portion of the losses between $500 million and $600 million. *Id.* at 270. Since $300 million of the contracts covered by the reinsurance from AIG were already reinsured with other carriers, General Re could not possibly suffer the minimum $500 million loss that would trigger AIG's first-dollar exposure. *Id.*
264. *Id.* at 273–74. While the court excluded a line graph showing the day-by-day AIG stock price, it "permitted the government to show a functionally identical chart to the jury during opening statements," and admitted "bar-charts showing single-day stock prices for the days following . . . publication" of "articles about [the reinsurance transaction's] impropriety." *Id.*

this evidence to show materiality, "exploited it to emphasize the losses caused by the transaction."[265] Since the stock price decline took place amidst revelations of AIG problems having nothing to do with the reinsurance contract (bid-rigging, self-dealing, and earnings manipulation)—references to which had to be redacted from publications shown to the jury—the jury might have attributed the full decline in the AIG stock price to the reinsurance deal.[266] "The charts suggested that this transaction caused AIG's shares to plummet 12%," a conclusion that the Second Circuit characterized as "without foundation."[267] The district court abused its discretion in admitting the charts.[268] The court of appeals held that the abuse affected the defendants' substantial rights and therefore vacated the convictions.[269]

The Second Circuit, however, rejected the defendants' attack on a "conscious avoidance" instruction ("that a defendant acted knowingly if he 'was aware of a high probability that [a] statement was false' but 'deliberately and consciously avoided confirming that fact'"[270]) insofar as it was used by the government to argue that the defendants—all of whom worked at General Re—knew that AIG would account for the deal as reinsurance, even though General Re would not.[271] Acknowledging that "'in general, conscious avoidance instructions are only appropriate where knowledge of an existing fact, and not knowledge of the result of defendant's conduct, is in question,'"[272] the court held that the reinsurance transaction was not a single isolated transaction but "developed over a number of months, and there were numerous forward-looking meetings, e-mails, and negotiations."[273] Hence, the conscious avoidance transaction, relating to a future action by a counterparty, was not error.[274]

The Second Circuit also found no error in the trial court's denial of an instruction that the attorney-defendant requested.[275] That defendant, who was an in-house lawyer at General Re working on the reinsurance transaction, had sent an e-mail to his superior (the company's General Counsel) that included

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265. *Id.* at 274. The prosecutor stated in rebuttal summation:

> [B]ehind every share of [AIG] stock is a living and breathing person who plunked down his or her hard-earned money and bought a share of stock, maybe [to] put it in their retirement[ ] accounts, maybe to put it in their kids' college funds, or maybe to make a little extra money for the family.

*Id.*

266. *Id.* at 273–74. The defendants could only fight this inference by introducing "prejudicial evidence of the other besetting scandals." *Id.* at 274. Note that (i) the defendants had attempted to avoid this Hobson's choice by offering to stipulate to materiality, an offer that the government declined, *id.*, and (ii) the government had other proof of materiality (testimony of stock analysts and an AIG investor relations professional). *Id.* at 274 n.10.

267. *Id.* at 275.

268. *Id.* at 274.

269. *Id.* at 267, 274–75.

270. *Id.* at 277.

271. *Id.* at 277–79.

272. *Id.* at 278 (quoting United States v. Gurary, 860 F.2d 521, 526 (2d Cir. 1988)).

273. *Id.* at 279.

274. *Id.*

275. *Id.* at 289–90.

language suggesting that the deal might be suspect.[276] Basing his request on state bar ethics rules, the attorney asked the district court to instruct the jury that "an attorney confronted with 'an arguable question of professional duty' may discharge his ethical responsibilities by consulting with a supervisory lawyer and relying on his resolution of the matter."[277] The court of appeals held that the e-mail on which this instruction was premised was simply a "report[] on what [was] being done" and therefore was "not the kind of consultation contemplated by the rules."[278]

*Significance and analysis*. The requested lawyer instruction deserves special comment. The American Bar Association's Model Rules of Professional Conduct provide that "[a] subordinate lawyer does not violate [those rules] if that lawyer acts in accordance with a supervisory lawyer's reasonable resolution of an arguable question of professional duty."[279] A comment adds that "the supervisor's reasonable resolution of the question should protect the subordinate professionally if the resolution is subsequently challenged."[280] While an ethical consultation with a superior attorney might well be relevant to the mental state of the subordinate lawyer, the rule provides protection only from bar sanctions, not violations of the securities law. Moreover, expressly referencing the rule in a jury instruction could interject into a case the terms "arguable question" and "reasonable resolution." Seizing on these terms, jurors might divert their attention to whether the defendant attorney had proved that the issue he or she raised did indeed present an "arguable question" and whether the supervising attorney did indeed provide a "reasonable resolution"—all of which could lead the jury to reverse the burden of proof and wander from the more stringent mental state standards required for a criminal conviction for securities fraud or related violations.[281]

**SEC Enforcement Actions**: *in an enforcement action against a brokerage, the materiality of the misrepresentations or omissions does not depend on the number of customers deceived*; *misrepresentation affecting only choice of broker, rather than investment decisions, is not "in connection with" the purchase or sale of securities*; *SEC*

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276. *Id.* The e-mail included these words:

> [General Re] will book the transaction as a deposit. How AIG books it is between them, their accountants and God; there is no undertaking by them to have the transaction reviewed by their regulators.
>
> [Ferguson [the General Re CEO]] et al[.] have been advised of, and have accepted, the potential reputational risk that U.S. regulators (insurance and securities) may attack the transaction and our part in it.

*Id.* at 290 (emphasis omitted; one alteration added).

277. *Id.* at 289.

278. *Id.* at 290.

279. MODEL RULES OF PROF'L CONDUCT R. 5.2 (2012). The Gen Re lawyer apparently relied on the Connecticut equivalent. *Ferguson*, 676 F.3d at 290 (citing Conn. Rules of Prof'l Conduct R. 5.2).

280. MODEL RULES OF PROF'L CONDUCT R. 5.2 cmt. 2.

281. Moreover, the prosecution could counter with Rule 1.2(d), which provides that "[a] lawyer shall not . . . assist a client . . . in conduct that the lawyer knows is criminal or fraudulent." MODEL RULES OF PROF'L CONDUCT R. 1.2 (2012).

*may deny appearance and practice privileges to an attorney upon a Commission finding that the attorney has violated the state bar ethical rules to which the attorney is subject and may do so without any state bar finding of such a violation.*

Last year produced two particularly notable court of appeals opinions in SEC enforcement actions. The Eleventh Circuit held that, when the SEC sues an entity for misrepresentations made by its employees, the SEC need not demonstrate that any particular number of investors was deceived in order to prove materiality and, in the same opinion, held that truthful written disclosures did not, under the circumstances, render oral misrepresentations immaterial as a matter of law.[282] The D.C. Circuit found that the SEC can withdraw the privilege of practicing before it from an attorney, based on the SEC's determination that the attorney violated state bar rules.[283]

*Materiality of misrepresentations and omissions in case against brokerage firm.* In *SEC v. Morgan Keegan & Co.*, the Commission alleged that individual brokers working for Morgan Keegan orally misrepresented the liquidity of auction rate securities ("ARS") to brokerage customers.[284] The Commission sought an array of remedies against Morgan Keegan—a permanent injunction against violating Rule 10b-5, an order requiring Morgan Keegan to repurchase the ARS, disgorgement of ill-gotten gains, and civil monetary penalties.[285] The district court granted summary judgment to the brokerage on the ground that the SEC had not raised a genuine issue of material fact as to materiality because the Commission—which cited the testimony of four customers and submitted written complaints from fourteen customers[286]—had provided evidence only of "'a few isolated instances of alleged broker misconduct.'"[287] The Eleventh Circuit reversed, holding that "there is no statutory or precedential support for Morgan Keegan's argument that some threshold number of investors must be misled before finding its brokers' misrepresentations 'material' in an SEC enforcement action."[288] Instead, "a misstatement or omission is material if there is a 'substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'"[289] Thus, Morgan Keegan's argument—"that an SEC enforcement action is designed to protect the public as a whole, and therefore the SEC must demonstrate that Morgan Keegan misled the public as a whole and not just a small subset of customers"—failed because "the Supreme Court's materiality standard analyzes the 'total mix' of information available to a hypothetical reasonable investor, not just to the public at large."[290] While the "extent of the brokers' misrepresentations may ultimately affect the size of the remedy, such as fines

282. *See infra* notes 284–301 and accompanying text.
283. *See infra* notes 302–21 and accompanying text.
284. 678 F.3d 1233, 1242–43 (11th Cir. 2012).
285. *Id.* at 1243.
286. *Id.* at 1242–43.
287. *Id.* at 1243–44 (quoting district court).
288. *Id.* at 1249.
289. *Id.* at 1245 (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976)).
290. *Id.* at 1247–48 (citing Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1318 (2011)).

or disgorgement imposed, . . . there is no minimum number of misrepresentations required for a materiality finding in an SEC enforcement action."[291]

The court of appeals also rejected Morgan Keegan's argument that the oral statements of the brokers were not material in light of written disclosures that the firm had made in a brochure, on its webpage, and in trade confirmations.[292] After observing that the SEC does not need to prove that any investor justifiably relied on a misstatement,[293] the court nevertheless noted that "the main securities cases the parties cite from our circuit addressing the interplay of written disclosures and oral misrepresentations" were private cases involving justifiable reliance[294] and that those cases demonstrated that "whether written disclosures should trump oral misrepresentations is highly fact-specific and therefore is not amenable to bright-line rules."[295] The court then stated that "[t]he oral misrepresentations at issue here were made directly to customer-investors who aver they never received or knew about the written disclosures at the time of their purchases" and that the "factual context" showed "a weak, or non-existent, distribution of the written disclosures."[296] The court also rejected the notion that the oral statements were immaterial because the written disclosures "were available to any '*reasonably diligent investor*,'" as the rule that the investor must exercise due diligence, or risk loss, is a concept appropriate to private lawsuits but not SEC enforcement actions.[297] Hence, the district court should not have granted summary judgment.[298]

*Significance and analysis*. The court was surely correct in holding that materiality is unaffected by the number of investors deceived and that that number is relevant to such matters as the scope of remedies and—even though the court had no occasion to say so—also to the question of whether the SEC will exercise its discretion to bring an enforcement action against an entity.[299] The Eleventh Circuit's analysis of the materiality of oral statements contrary to written disclosures is less satisfying. Courts have long held that warnings or truthful statements can affect the materiality of allegedly misleading representations.[300]

291. *Id.* at 1249. The court added: "The problem for Morgan Keegan is the SEC enjoys the authority to seek relief for any violation of the securities laws, no matter how small or inconsequential." *Id.* at 1248. And the court noted that Morgan Keegan was responsible for the alleged misrepresentations by its brokers "[u]nder principles of *respondeat superior*." *Id.* at 1249.

292. *Id.* at 1250–53.

293. *Id.* at 1244.

294. *Id.* at 1250.

295. *Id.* at 1252.

296. *Id.*

297. *Id.* at 1253.

298. *Id.*

299. For example, the SEC has stated that the question of whether it will seek financial penalties against an issuer on the basis of misstatements or omissions turns in part on "[t]he extent of the injury to innocent parties" which in turn is affected by, among other things, "the number of investors injured." U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm.

300. *See*, *e.g.*, Ganino v. Citizens Utilities Co., 228 F.3d 154, 167 (2d Cir. 2000) ("a misrepresentation is immaterial if the information is already known to the market because the misrepresentation cannot then defraud the market"); *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1414 (9th Cir.

Analyzing that concept through the justifiable reliance cases, as the Eleventh Circuit did, is questionable. Doctrinally, the materiality question is simply whether—in light of available written truth—there is a substantial likelihood that a reasonable investor would have attributed actual importance to the oral misstatement. That question is best analyzed, particularly in the context of an SEC enforcement action, by asking whether the misstatement would have been important to any investor falling within the wide range of reasonable investors rather than by focusing on the individual characteristics of investors, as do the decisions that address justifiable reliance.[301]

*Attorney discipline by SEC based on violation of state ethics rules and without any state bar action*. In an extremely important case for attorneys, the D.C. Circuit addressed in *Altman v. SEC* whether the Commission could bar a lawyer from SEC practice on the basis that the attorney violated state bar ethics rules.[302] Altman practiced in New York State and represented a witness that the Division of Enforcement had subpoenaed in a proceeding against the company at which the witness had formerly worked and with which the witness was negotiating a severance package.[303] Altman told the lawyer for the company that, if the company would pay the witness a year's salary and remove her as a co-signor on two car leases, the witness either would not cooperate with the SEC or would not remember facts that the SEC might use to disprove a defense that the company was raising in the SEC enforcement proceeding.[304]

The SEC proceeded against Altman under the SEC's practice rule 102(e)(1)(ii), which provides that "'[t]he Commission may . . . deny, temporarily or permanently, . . . the privilege of appearing or practicing before it . . . to any person who is found by the Commission . . . [t]o be lacking in character or integrity[,] or to have engaged in unethical or improper professional conduct[.]'"[305] The Commission found that the attorney, as the court summarized it, "knowingly violated three New York Bar disciplinary rules"—the rules (i) "prohibiting 'conduct involving dishonesty, fraud, deceit, or misrepresentation,'" (ii) "prohibiting 'conduct that is prejudicial to the administration of justice,'" and (iii) "prohibiting 'conduct that adversely reflects on the lawyer's fitness as a lawyer.'"[306]

1994) ("'the "bespeaks caution" doctrine has developed to address situations in which optimistic projections are coupled with cautionary language—in particular, relevant specific facts or assumptions—affecting the reasonableness of reliance on and the materiality of those projections. To put it another way, the "bespeaks caution" doctrine reflects the unremarkable proposition that statements must be analyzed in context.'" (quoting Rubinstein v. Collins, 20 F.3d 160, 167 (5th Cir. 1994))).

301. *See Morgan Keegan*, 678 F.3d at 1251 n.23 (citing Bruschi v. Brown, 876 F.2d 1526, 1529 (11th Cir. 1989)) (whether reliance on oral representations contradicted by written disclosures is justified depends on such factors as "the sophistication and expertise of the plaintiff in financial and security matters," "the existence of long standing business or personal relationships between the plaintiff and the defendant," and "the existence of a fiduciary relationship owed by the defendant to the plaintiff").

302. 666 F.3d 1322 (D.C. Cir. 2011).

303. *Id.* at 1325.

304. *Id.*

305. *Id.* at 1326 n.2 (quoting 17 C.F.R. § 201.102(e)(1)).

306. *Id.* at 1325 n.1 (quoting NY Disciplinary Rules 1-102(A)(4), 1-102(A)(5), 1-102(A)(7)). The lawyer's conduct occurred in 2004, *id.* at 1325, before the New York Bar adopted revised Rules of

In denying the lawyer's petition for review of the resulting SEC order[307] imposing a permanent bar on appearing and practicing before the Commission,[308] the D.C. Circuit held, first, that the SEC had the authority to impose sanctions under SEC Rule 102(e) based on violations of state bar ethics rules.[309] Rule 102(e) permitted the Commission to deny practice privileges based on "unethical and improper conduct" and it was "permissible" for the SEC to interpret "unethical and improper conduct" to include violation of state bar rules. Rejecting Altman's argument that the Commission had improperly barred him even though the New York state bar had taken no disciplinary action and the SEC had previously failed to act without such state bar discipline or a criminal conviction, the D.C. Circuit found that the SEC "did not lack authority to act because of previous pronouncements that it would generally not do so without prior judicial or administrative findings of misconduct,"[310] as "the Commission's 'powers . . . [were] not lost by being allowed to lie dormant.'"[311] Nor did any separation of powers principle require the SEC to wait for the New York State bar to bring and finish any disciplinary proceeding against the attorney, since the "sanction imposed on Altman is limited to appearances before the Commission and has no effect either on his ability to practice law in New York State and to appear before any court, or on New York State's authority to discipline him."[312] The appellate court held, second, that Altman had sufficient notice that he might be sanctioned by the SEC based on state bar rule breaches both because of a 1981 Commission decision referring to professional norms[313] and a footnote in the 2002 proposing release for the SEC's own standards for attorney conduct, which states that Rule 102(e) imports state bar ethics standards.[314]

*Significance and analysis*. The SEC's relationship with state bar ethics rules is a strange one. When the Sarbanes-Oxley Act required the SEC to promulgate its own ethics rules to require attorneys appearing and practicing before the Com-

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Professional Conduct, effective April 1, 2009, that replaced the old Disciplinary Rules. Press Release, N.Y. State Unified Court Sys., New Attorney Rules of Professional Conduct Announced (Dec. 16, 2008), *available at* http://www.nycourts.gov/press/pr2008_7.shtml.

307. *Altman*, 666 F.3d at 1329.

308. *Id.* at 1325.

309. *Id.* at 1325–27. The court noted that "Rule 102(e)(1)(ii) of the Commission's Rules of Practice was codified as Section 4C of the Act as part of the Sarbanes-Oxley Act of 2002, Pub. L. [No.] 107-204, 116 Stat. 745 (2002) (codified as 15 U.S.C. § 78d-3(a)(2))." *Id.* at 1326. The opinion referred to SEC decisions interpreting Rule 102 (and its predecessor Rule 2(e)) to encompass attorney norms and rules of professional conduct, and held that the 2002 "codification" of Rule 102(e) provided "persuasive evidence" that Congress approved of those Commission decisions. *Id.* (quoting Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 846 (1986) (quoting NLRB v. Bell Aerospace Co., 416 U.S. 267, 274–75 (1974))) (internal quotation marks omitted).

310. *Id.* at 1327.

311. *Id.* (quoting United States v. Morton Salt Co., 338 U.S. 632, 647 (1950)).

312. *Id.*

313. *Id.* at 1326 (citing *In re* Carter & Johnson, 47 S.E.C. 471, 508 (Feb. 28, 1981)).

314. *Id.* at 1328 (quoting Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71671 n.13 (Dec. 2, 2002) ("Rule 102(e) does not establish professional standards. Rather, the rule enables the Commission to discipline professionals who have engaged in improper professional conduct by failing to satisfy the rules, regulations or standards to which they are already subject, *including state ethical rules governing attorney conduct*." (emphasis added))).

mission to report corporate wrongdoing "up the ladder" in public companies,[315] the SEC specifically provided that (i) it could sanction an attorney for violation of *its* rules "regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices" and (ii) "[a]n attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices."[316] Moreover, one provision in the SEC rules—permitting an attorney, under certain circumstances, to report wrongdoing to the Commission if the company the attorney represents fails to adequately respond after the attorney reports wrongdoing—was contrary to some state law.[317] But despite the Commission's willingness to push state ethics rules out of the way when doing so suits the Commission's purpose at the moment, the SEC was quite content in Altman's case to rely on the state bar rules, and the D.C. Circuit was equally content to hold that Altman was on notice of this reliance by a 1981 SEC decision and a footnote in a 2002 proposing release,[318] even though the court acknowledged that "Altman is a general commercial litigator who has rarely practiced before the Commission."[319]

The *Altman* case seems easy because the attorney's actions—seeking payment for a witness's noncooperation with a subpoena or false testimony—is so obviously wrong that the SEC should be able to bar the lawyer taking that action from Commission practice. As the Second Circuit put it, Altman "cannot seriously suggest that he lacked notice that conduct in the nature of a fraud on

315. SOX, *supra* note 243, § 307, 116 Stat. at 784 (codified at 15 U.S.C. § 7245 (2006)).

316. 17 C.F.R. 205.6(b), (c) (2012).

317. The SEC rules state:

> An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:
>
> (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
>
> . . . or
>
> (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

17 C.F.R. § 205.3(d)(2) (2012). This permission conflicts with, for example, California Business and Professional Code section 6068(e)(1), which provides that an attorney must "maintain inviolate the confidence, and at every peril to himself or herself . . . preserve the secrets, of his or her client," excepting only, in section 6068(e)(2), that the lawyer may "reveal confidential information relating to the representation of a client to the extent that the attorney reasonably believes the disclosure is necessary to prevent a criminal act that the attorney reasonably believes is likely to result in death of, or substantial bodily harm to, an individual." *See Ethics Alert: The New SEC Attorney Conduct Rules v. California's Duty of Confidentiality*, Ethics Hotliner, Spring 2004, at 4–5, *available at* http://ethics.calbar.ca.gov/LinkClick.aspx?fileticket=7xTdfWYEC3k%3D&tabid=834 (explaining that the SEC rules appear to conflict with California Business and Professional Code section 6068).

318. *Altman*, 666 F.3d. at 1327–28.

319. *Id.* at 1325.

Commission proceedings falls within the purview of Rule 102(e)."[320] But it is odd that, to hang the lawyer for such conduct, the SEC had to reach to incorporation of state bar rules, which the Commission is pleased to ignore when those rules conflict with SEC policy. The SEC and the court might just have easily rested the sanction against Altman on the alternative Rule 102(e) ground that he "was lacking in character or integrity."[321]

**Private Securities Litigation Reform Act ("PSLRA") Pleading**: *questionable materiality of undisclosed facts sapped inference that omissions were made with scienter; caution accompanying representation of "sufficient liquidity" to meet margin calls helped defeat scienter inference; scienter not sufficiently pled where medical device company stated adverse results were the result of implantation technique and the statement was a judgment based on differing surgical results—in the United States and Europe—with the same device.*

The PSLRA[322] placed a provision in the Exchange Act requiring that, when pleading a securities lawsuit under Rule 10b-5, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[323] The PSLRA also inserted a provision requiring that, where a private Rule 10b-5 plaintiff seeks a monetary recovery, "the complaint shall, with respect to each act or omission . . . , state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,"[324] which is scienter in such a case.[325] Scienter "refers to a mental state embracing intent to deceive, manipulate, or defraud"[326] and also includes severe recklessness, characterized most frequently as conduct "'involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the [defendant] must have been aware of it.'"[327] The Supreme Court has held that, to determine whether a plaintiff satisfies the PSLRA scienter pleading standard, a court must consider allegations in a complaint, together with judicially noticeable material, and determine whether—taken together and examining both pejorative and benign inferences from all of them—the allegations and noticed facts raise an inference of scienter that is "cogent and at least as compelling as any opposing inference of nonfraudulent intent."[328] With some exceptions,

320. *Id.* at 1328.

321. 17 C.F.R. § 201.102(e)(1)(ii) (2012).

322. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.) [hereinafter PSLRA].

323. PSLRA § 101(b), 15 U.S.C. § 78u-4(b)(1) (2006).

324. PSLRA § 101(b), 15 U.S.C. § 78u-4(b)(2) (2006 & Supp. V 2011).

325. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976).

326. *Id.* at 194 n.12.

327. Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044–45 (7th Cir. 1977); 8 LOUIS LOSS ET AL., SECURITIES REGULATION 156 (4th ed. 2012) (finding this formulation of Rule 10b-5 recklessness the "most widely followed approach").

328. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

the PSLRA stays discovery while defendants move to dismiss on the basis that plaintiffs have failed to meet these special pleading standards.[329] Defendants file such motions in virtually every securities class action, and, not surprisingly, the outcomes of such motions affect settlements.[330]

Last year the First Circuit held in two cases—one involving the failure to disclose steps that allegedly rendered a backlog of orders unreliable and one involving the failure to disclose that sales personnel had been fired by the defendant and hired by a competitor—that the weakness of allegations going to the materiality of the omissions supported the conclusion that the plaintiffs failed to adequately plead scienter.[331] The Seventh Circuit found scienter inadequately pled as to a representation that a company in the securitized mortgage market had "substantial liquidity" to meet margin calls, in part because the representation was accompanied by warnings that the liquidity might not prove sufficient.[332] The Seventh Circuit also held that a plaintiff failed to raise a strong inference of scienter concerning statements by a company manufacturing hip sockets, where the company attributed adverse outcomes to doctor technique and it was reasonable to conclude that the attribution was based not on fraud but on different outcomes—in Europe and the United States—with the same device.[333]

*Statements concerning backlog allegedly weakened by undisclosed steps to obtain orders from less creditworthy customers; paucity of materiality allegations contributed to failure of scienter pleading*. In *Automotive Industries Pension Trust Fund v. Textron, Inc.*,[334] the First Circuit affirmed dismissal[335] of a Rule 10b-5 case[336] brought against Textron and several senior executives based on allegedly fraudulent statements about backlog at Textron's Cessna Aircraft Company subsidiary, which provided about 40 percent of Textron's revenue.[337] As examples of the challenged statements, Textron's CEO (i) "said in January 2008 that Cessna was seeing 'unusually low cancellations'"; (ii) said "in October 2008 . . . that '[c]ancellations are not even noteworthy'"; and (iii) stated in early November 2008: "[W]e believe our record aerospace and defense backlog and pending customer orders of nearly $30 billion will provide a cushion and ballast to weather the uncertainties we face as we go forward."[338] Textron announced on January 29, 2009, that it was cutting Cessna production in part due to cancellation of twenty-three orders and "'an unprecedented number'" of delivery date deferrals.[339]

329. PSLRA § 101(b), 15 U.S.C. § 78u-4(b)(3)(B) (2006).

330. *See* Renzo Comolli et al., Recent Trends in Securities Class Action Litigation: 2012 Full-Year Review 16 (2013); Ronald I. Miller. Dynamic Litigation Analysis: Predicting Class Action Settlements as a Case Evolves 4–5 (2013).

331. *See infra* notes 334–69 and accompanying text.

332. *See infra* notes 370–83 and accompanying text.

333. *See infra* notes 384–97 and accompanying text.

334. 682 F.3d 34 (1st Cir. 2012).

335. *Id.* at 40.

336. *Id.* at 36 n.2.

337. *Id.* at 35.

338. *Id.* at 36.

339. *Id.*

Plaintiffs alleged that the Textron executives' statements misled by omitting, from the statements before January 29, 2009, facts showing that the backlog was soft, particularly that Cessna (i) had lowered its underwriting standards in making loans to customers, thereby attracting more orders by more risky buyers more likely to cancel; (ii) was financing 100 percent of the deposits by some customers, which needed the financing because of their shaky financial condition, and which were—because of that shaky condition—more likely to cancel; (iii) was accepting orders from overseas Authorized Sales Representatives ("ARS") who did not have commitments from end-user buyers; and (iv) was pressuring customers to delay rather than cancel orders.[340] The court of appeals discounted Textron's "general warnings about the possibility of cancelled orders,"[341] saying that, while those "warnings might insulate Textron from liability for 'forward-looking statements' like revenue projections," they would not constitute a defense against a suit "for intentionally misleading characterizations of the present or historical state of the backlog."[342]

Since the allegedly undisclosed facts about the backlog would have to be material in order for the plaintiffs to plead a claim,[343] the court examined the allegations going to that element and found them inconclusive because it was "hard to assess whether disclosures would have altered the total mix of available information for a reasonable investor."[344] Textron had provided some warnings about its backlog.[345] And the complaint suffered from "lack of detail surrounding the allegedly relaxed underwriting standards and the effect on the backlog."[346]

Turning from materiality to scienter, the First Circuit found no particular facts in the complaint to suggest "that any of the named officers believed, or was recklessly unaware, that the backlog's significance had been undermined by weakened underwriting standards, sales to intermediates, or any of the other flaws on which the plaintiffs rely."[347] Relating this scienter conclusion to its materiality analysis, the court found that the "questionable materiality of the practices" supposedly weakening the backlog "deprive[d plaintiffs of] any inference" that the top managers intended to deceive or were severely reckless in any misdirection their statements induced.[348] Effectively, the court reasoned that since the defendants had reasons for believing that the undisclosed facts—to the extent they existed—did not adversely affect the backlog, the defendants could not have been deliberately deceptive in failing to disclose those facts. Thus, while plain-

340. *Id.* at 37.

341. *Id.* at 38.

342. *Id. see* 15 U.S.C. § 78u-5(c)(1)(A)(i) (2006).

343. *Textron*, 682 F.3d at 37.

344. *Id.* at 38.

345. The Textron CEO said in June 2008 "that '[p]ortions of our backlog are susceptible to normal cancellations or deferrals. And we'll likely see cancellations.'" *Id.* at 38 n.3. The company "also repeatedly warned in SEC filings and press releases of the risk of 'changes in aircraft delivery schedules or cancellation of orders,' and that '[a]ircraft customers . . . may respond to weak economic conditions by delaying delivery of orders or canceling orders.'" *Id.*

346. *Id.* at 38.

347. *Id.* at 39.

348. *Id.*

tiffs contended that Textron was financing deposits, the company countered that "financing deposits did not mean they were refundable."[349] While plaintiffs focused on sales through ASRs, "nothing show[ed] that ASR sales were unusual" during the period of the asserted fraud.[350] Accordingly, "while the relatively detailed factual proffers in the complaint [went] some distance toward making a case for materiality, they [were] considerably weaker in offering any direct evidence of guilty knowledge or fraudulent intent."[351] The court concluded that the scienter allegations "did not even arguably fall into a gray area encouraging further proceedings."[352]

*Positive statements concerning sales force made without disclosing that company was firing some sales representatives who went to work for a competitor; questionable materiality of firings made scienter inference improper*. In a second case relating materiality to scienter, the First Circuit examined statements Boston Scientific Corporation ("Boston Scientific") made about its work force at several points during a time when the company investigated certain sales employees in the portion of its business devoted to cardiac rhythm management ("CRM") devices and then fired the employees for misconduct, and also fired a Divisional Vice President of Sales.[353] A competitor hired many of those employees (and the vice president) and, when Boston Scientific announced the firings (together with some other bad news), it publicly predicted that it could lose $100 million in sales.[354] Investors sued Boston Scientific, its CEO, and its Executive Vice President (who was also President of its CRM group) for failing to disclose the firings while saying (i) on October 20, 2009, that the company was training 150 new sales trainees for the CRM business and had "solid growth" in that business; (ii) on November 6, that "additional [CRM] sales representatives will generate incremental net sales in future periods"; (iii) on December 10 and 14, that Boston Scientific's ability to deliver on forward-looking statements in offering documents would depend on, among many other things, the company's "ability to retain key members of our CRM sales force and other key personnel"; and (iv) on January 12, 2010, that the company, as a whole, had a "stable, large, experienced" and "very successful" sales force.[355] Only later—in February 2010—did Boston Scientific reveal that it had discharged the CRM sales representatives and that the competitor had hired most of them.[356] At the same time, Boston Scientific predicted that it would lose $100 million in sales.[357] Months later, the company stated that the

349. *Id.*

350. *Id.*

351. *Id.* at 40. Plaintiffs also pointed to stock sales by the Textron CEO and one other executive during the alleged fraud. *Id.* But these allegations did not add much to the scienter analysis as they were unaccompanied by comparative sales figures from outside the class period that would permit an inference that the in-period sales were unusual. *Id.*

352. *Id.*

353. *In re* Bos. Scientific Corp. Sec. Litig., 686 F.3d 21, 24–26 (1st Cir. 2012) (timeline of statements, disciplinary actions, and hiring by competitor).

354. *Id.* at 25, 29.

355. *Id.* at 24–25.

356. *Id.* at 30.

357. *Id.* at 29 ($100 million prediction in February 11, 2010 conference call), 30 (firings disclosed in February).

firings, and a product advisory about unsafe outcomes using CRM devices, had in fact cost Boston Scientific only $16 million in the first quarter of 2010, when the company's revenues were $538 million.[358]

Addressing first materiality, the court noted that the firings had not even begun by the time the first two statements were made and, when the firings did go forward, Boston Scientific discharged only ten CRM sales representatives (out of the CRM 1100 person sales force) while hiring 150 new CRM sales trainees and, further, that while CRM sales constituted 30 percent of the company's total revenues, Boston Scientific overall had 25,000 employees.[359] The court then stated that "the possible or imminent discharge of a tiny fraction of sales personnel for a single line of products remains of minimal expected consequence for a company with global operations and 25,000 employees" and that these numbers were "not even close to the level at which other cases have found omissions to be material."[360]

The plaintiffs alleged that the ten CRM sales representatives and the CRM divisional vice president for sales *had* been fired before the December 10 and 14 statements.[361] But the failure to discuss those firings in those statements was not a material omission. As to the sales representatives: "That ten representatives out of 1,100 had been fired while 150 new ones were being trained does not amount to material information."[362] As to the vice president for sales, while the materiality of his departure was a "closer call," he had no personal relationship with the doctors who would prescribe the CRM devices, and in any event it "was not plainly foreseeable" when the December statements were made that he "would defect [to a competitor] and take other discharged salesmen with him."[363]

This left the January 12, 2010 statement that the company, as a whole, had a "'stable, large, experienced'" and "'very successful'" sales force, and the First Circuit assumed (without deciding) that the district court had properly ruled the failure to disclose the various firings at this later date was a material omission because, by this time, the competitor had begun to hire the former Boston Scientific sales representatives.[364] The court of appeals, however, found no adequate allegations from which to draw a strong inference of scienter as to that omission in part because "some or all of the fired employees had only very recently been hired by [the competitor], and how much business they might take with them

358. *Id.* at 26. In response to an SEC inquiry, the company later characterized the actual losses from the firings as "immaterial" to results in the fourth quarter of 2009. *Id.*

359. *Id.* at 24 (CRM 30 percent of total sales; CRM had about 1100 employees), 28 (only ten discharged), 28 (Boston Scientific employed about 25,000 worldwide).

360. *Id.* at 28–29.

361. *Id.* at 25 (vice president discharged on December 11 or 12, 2009), 29 (ten sales representatives fired before December 9).

362. *Id.* at 29.

363. *Id.*

364. *Id.* at 30 (quoting CEO). At one point, the First Circuit suggested that the $100 million in sales that Boston Scientific later (in February) forecast it might lose was not material, saying that "in that same [February] conference call, Boston Scientific projected 2010 revenues of $8.1 billion to $8.5 billion, making the projected loss just over one percent of revenues and not necessarily a permanent loss of business." *Id.* at 29.

surely required some period to assess."[365] Moreover, and here the court used its materiality analysis in its scienter analysis, the competitor's hiring of the discharged Boston Scientific personnel "was at best marginally material," and "its marginal materiality not only defeats any independent inference of deliberate withholding but also makes the pled facts insufficient for a fact finder to find the 'extreme recklessness in not disclosing the fact' that is the least that is required to establish scienter."[366] With most of the omissions immaterial and the one of arguable materiality not sufficiently pled to have been made with scienter, the First Circuit affirmed the district court's order dismissing the case.[367]

*Significance and analysis*. Scienter and materiality are separate elements. Blending them together risks diluting the special statutory pleading rule that applies to mental state.[368] Nevertheless, there is some sense to considering them side by side, at least for purposes of finding that a plaintiff *has not* pled scienter. As a commonsense matter, management will not believe that it is deceiving by failing to disclose some development that seems immaterial. On the other hand, courts generally have been loath to find that a plaintiff *has* sufficiently pled scienter by relying on the magnitude of the adverse development defendants fail to disclose, except (at least in some circuits) in very rare cases where the omitted facts loom so large that it would be extremely hard to believe that the company's top management had no knowledge of them.[369]

*Representation of "substantial liquidity" during the financial meltdown; scienter not pled in part because the statement was accompanied by a warning that liquidity might not be adequate to cover margin calls and in part because the financial crisis caught even experts by surprise*. In a case arising out of the financial crisis, the Seventh Circuit affirmed dismissal of a Rule 10b-5 action against a publicly traded company that owned 46 percent of the equity interests in a limited liability company that securitized residential home mortgages—*Fulton County Employees Retirement System v. MGIC Investment Corp*.[370] The LLC borrowed money to buy the mort-

365. *Id.* at 31.

366. *Id.*

367. *Id.* at 26–27, 32.

368. As set out in *supra* notes 322–28 and accompanying text, the PSLRA imposes strict, but separate, pleading standards for alleging (i) that statements were misleading and (ii) that defendants had scienter.

369. *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702, 710 (7th Cir. 2008) (if "General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero," then "[t]here would be a strong inference of corporate scienter"); South Ferry LP, #2 v. Killinger, 542 F.3d 776, 786 (9th Cir. 2008) (allegations that top management knew of deterioration in core operations "may conceivably satisfy the PSLRA standard in a . . . bare form . . . in rare circumstances where the nature of the relevant fact is of such prominence that it would be 'absurd' to suggest that management was without knowledge of the matter"). *But see* Frederick v. Mechel OAO, 475 F. App'x 353, 356–57 (2d Cir. 2012) (stating that the Second Circuit has not decided whether the "core operations" theory of scienter pleading survived the PSLRA; finding allegations inadequate even if the theory retained resilience where the omitted fact was "anticompetitive practices with regard to a limited number of interactions with two or three customers").

370. 675 F.3d 1047, 1048, 1052 (7th Cir. 2012). Although the court of appeals opinion does not state that the plaintiff sued under Rule 10b-5, the district court decision does. Fulton Cnty. Emps. Ret. Sys. v. MGIC Inv. Corp., No. 08-C-0458, 2010 WL 601364, at *1 (E.D. Wis. Feb. 18, 2010).

gages it securitized, and the terms of those borrowings—which were secured by pools of the mortgages—required the LLC to post additional collateral ("margin calls") if the value of the mortgages declined.[371] MGIC stated in a July 19, 2007 press release that the LLC "maintains substantial liquidity to cover margin calls in the event of substantial declines in the value of its mortgages and securities."[372] But MGIC added in the next sentence: "While [the LLC's] policies governing the management of capital risk are intended to provide sufficient liquidity to cover an instantaneous and substantial decline in value, such policies cannot guarantee that all liquidity required will in fact be available."[373]

As margin calls on the LLC continued, it ran out of additional assets to post, and, on July 30, MGIC announced that its investment in the LLC was "materially impaired."[374] The Seventh Circuit held that the complaint failed to plead facts suggesting that it was just as likely as not that MGIC had scienter when it said that the LLC maintained "substantial liquidity" for margin calls. First, the LLC had—at the time MGIC made the statement—$150 million of assets available for margin calls, which was equal to the amount it had posted in response to margin calls during the preceding six-and-one-half months.[375] Second, the statement was embedded in a paragraph that expressly warned that the LLC might not have sufficient liquidity.[376] Third, even after the July 19 press release, MGIC continued to put capital into the LLC, an action MGIC would not have taken if MGIC had thought that the LLC was destined to fail for illiquidity.[377] Fourth, the deepening financial crisis that brought the LLC down "took many experts by surprise."[378]

Then the court ended its scienter discussion with a duty-to-disclose analysis. The Seventh Circuit rhetorically asked "[w]hat new information" MGIC was supposed to have disclosed?[379] Answering, the court posited that the only information that led to the LLC's margin calls was "market-wide" rather than "company-specific" and wrote that the "[s]ecurities law requires issuers to disclose firm-specific information, not news that concerns the industry or economy as a whole."[380] Concluding this thought, the court held that "[i]ssuers need not be prescient" and that "MGIC had no duty to foresee the future."[381]

*Significance and analysis*. The Seventh Circuit's reliance on the close coupling of the "substantial liquidity" representation with warnings that the liquidity

371. *MGIC Inv. Corp.*, 675 F.3d at 1049.
372. *Id.* at 1048.
373. *Id.*
374. *Id.* at 1049.
375. *Id.*
376. *Id.* The press release also contained the additional caution: "'Our income from joint ventures [like the LLC] could be adversely affected by credit losses, insufficient liquidity or competition affecting those businesses'" and "went on to detail problems MGIC was encountering, including the liquidity risk at [the LLC]." *Id.* at 1050.
377. *Id.*
378. *Id.*
379. *Id.*
380. *Id.*
381. *Id.* at 1050–51.

might not be enough provides some comfort to companies trying, as the court put it, to strike a "balanc[e]" between "let[ting] investors know about . . . trouble without painting too gloomy a picture."[382] But the greater question—the one raised by the court's ramblings about issuers not having to predict the future—is how an issuer can provide adequate disclosure during an ongoing crisis like the financial meltdown. The court at no point states that MGIC was required to provide the "substantial liquidity" assurance at all, even in the qualified form it took. But once the company did so, how could that not implicate adequacy of the liquidity for future margin calls? Indeed, what was the point of the representation if not to calm fears that the LLC would be unable to meet such future calls? And if a company chooses to make such a representation, then why should it not be called on to predict the future—including *the effect on the LLC* of market-wide events?[383] The court would have been wise to affirm dismissal without the unnecessary and confusing duty-to-disclose sentences tacked on as an afterthought to well-reasoned scienter analysis.

*Scienter not adequately alleged where statements reflected a judgment defendants made based on differing results by different doctors with a medical device; scienter pleading also inadequate for a literally true response to a question in a conference call*. The plaintiff in *Plumbers & Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc*. sued the manufacturer of an artificial hip joint socket (and its top officers), alleging that they violated Rule 10b-5 by (i) responding to a well-known surgeon's report of unacceptably high failure rates by attributing that rate to improper surgical technique and (ii) waiting to disclose quality control problems at a Dover, Ohio manufacturing facility until January 2008 even though they knew of the problems in late 2007.[384] Affirming the trial court's order granting the defense motion to dismiss and denying plaintiffs leave to amend,[385] the Seventh Circuit found no adequate inference of scienter on the first issue because the defendants knew that, even though one famous surgeon (who operated in the United States) reported 20 percent failures, doctors had been implanting the same device for years in Europe with only 1 percent failures.[386] The defendants could therefore have believed that the differing results were due to implantation technique, and nothing in the complaint made a fraudulent explanation for the defendants' statements at least as compelling as this innocent explanation.[387] As to the second issue, the court held that

382. *Id.* at 1050.

383. The court's implication that securities laws do not require issuers to disclose more than "company-specific" information is not entirely accurate. For example, Item 303 of Regulation S-K can require that an issuer disclose the effect of a marketwide trend *on that issuer*. *See* Litwin v. Blackstone Grp., L.P., 634 F.3d 706, 718–19 (2d Cir.), *cert. denied*, 132 S. Ct. 242 (2011).

384. 679 F.3d 952, 953 (7th Cir. 2012). The court of appeals does not clearly state the rule or statute on which it was brought, but does discuss scienter. The trial court opinion confirms that the plaintiffs sued under Rule 10b-5. Plumbers & Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc., No. 1:08-cv-01041-SEB-DML, 2011 WL 338865, at *17 (S.D. Ind. Jan. 28, 2011). The defendants included Zimmer's CEO and CFO. *Id.* at *1.

385. *Zimmer*, 679 F.3d at 954, 957.

386. *Id.* at 954.

387. *Id.* at 954–55.

"quality control is an issue at all medical companies" and that "[k]nowing of 'problems,' which are common, differs from knowing that a facility must be closed and some of its products recalled."[388] Nothing that the plaintiffs alleged—including discussions of quality control issues at internal Zimmer meetings, or coaching of Zimmer employees on what to say to FDA inspectors, or the company's hiring of a specialist to assist in avoiding FDA warning letters—permitted an inference of the requisite guilty knowledge (in 2007) that the problems would mature into an interruption of production at Dover,[389] as they did in April 2008.[390]

The court then focused on a very particular matter that plaintiff's counsel brought to the court's attention during oral argument on the scienter issue—whether the Zimmer CEO had lied during the following exchange in a January 2008 conference call with financial analysts:

> Q: All right, and you mentioned you talked about investing in compliance and systems. Do you currently have any issues with the FDA, any warning letters, that usually takes a few months for those to be posted, that they may have been issued or 483'ed?
>
> A: We don't have any warning letters at this point.[391]

The court explained that, "[i]n industry jargon, a '483' is an observation by an [FDA] inspector, providing information about 'significant objectionable conditions' (not serious enough to merit a warning or any formal action by the agency) that the inspector believes will be useful to the company"—an observation recorded on a Form 483.[392] The plaintiffs contended that an FDA inspector had provided eight 483 observations to Zimmer during a nine-day inspection that ended on the day of the conference call in which the above exchange occurred.[393]

The Seventh Circuit commented that it was unclear "how quickly these 483 observations reached Zimmer's CEO," which would determine whether the CEO knew of them when he provided his answer during the conference call.[394] More significantly, the court said that "[a]t all events, it is hard to call a truthful answer to a compound question 'fraud.'"[395] Potentially even of greater importance, the court then wrote:

> Oral exchanges are less precise than written ones. [The CEO] did not know what question was coming, had to answer off the cuff, and did not have an opportunity to review the question and edit his answer before the next question was posed. This question mentioned warnings first, and [the CEO] said that Zimmer had not received any. The questioner could have followed up about 483 observations, but didn't. . . . The worst one could say about [the CEO's] answer is that it was evasive, which is short of fraudulent.[396]

388. *Id.* at 955.
389. *Id.*
390. *Id.* at 954.
391. *Id.* at 955.
392. *Id.*
393. *Id.* at 956.
394. *Id.*
395. *Id.*
396. *Id.*

*Significance and analysis*. The court's treatment of the analyst call exchange may give some comfort to executives participating in such calls. But clients should, of course, go beyond literally true answers because even those can sometimes mislead by omission.[397] Not all courts will agree that a medical device executive displays no scienter when failing to disclose 483s—assuming that he or she is aware of the 483s at the time of speaking—because the executive is responding to a "compound" question, one part of which specifically mentions 483s, in an analyst conference call that the company has organized.

**Loss Causation**: *stock price rebound after corrective disclosure does not defeat loss causation at the pleading stage; no loss causation shown in case based upon a bank's alleged concealment of risk in its commercial loan portfolio where plaintiff's expert controlled for non-fraud factors that could affect stock price by using the S&P 500 Index and the NASDAQ Bank Index but did not control for deterioration in the Florida real estate market where defendant made the loans; statutory requirement to prove loss causation does not foreclose rescission remedy, but plaintiff seeking rescission must prove that the defendant's acts caused damages justifying that remedy*.

A private plaintiff suing under Rule 10b-5 must plead and prove economic loss and that the securities violation caused that loss.[398] The PSLRA placed the loss causation element in the Exchange Act, by a section providing: "[i]n any private action arising under [that Act], the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate [the Act] caused the loss for which the plaintiff seeks to recover damages."[399] In cases involving public companies, plaintiffs typically establish loss causation by showing that the price of the issuer's stock fell after disclosure of bad news—either revelation of the truth behind the fraud, or revelation of the fact that the defendant failed to disclose when under a duty to do so.[400]

Last year, the Second Circuit held that a plaintiff might plead loss causation even if the defendant's stock price quickly recovers after dropping on revelation of the truth.[401] The Eleventh Circuit held that a plaintiff's expert had not proved loss causation when the expert—in attempting to find the effect on a stock price decline of disclosures revealing the concealed risk—controlled for the portion of the decline that might have been caused by general stock market factors and the portion that might have been caused by industry factors, but failed to control for any portion of the decline that might have been caused by circumstances particular to the geographic market in which the defendant operated.[402]

397. *See* 17 C.F.R. § 240-10b-5(b) (2012) (prohibiting statements that mislead due to omission of material facts).

398. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342, 346–48 (2005).

399. *See* 15 U.S.C. § 78u-4(b)(4) (2006).

400. *Dura Pharms.*, 544 U.S. at 344 ("[T]he Restatement of Torts, in setting forth the judicial consensus, says that a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains 'when the facts . . . become generally known' and 'as a result' share value 'depreciate[s].' § 548A, Comment b, at 107.").

401. *See infra* notes 404–11 and accompanying text.

402. *See infra* notes 412–21 and accompanying text.

The Sixth and Ninth Circuits addressed the relationship between the rescission measure of damages and the statutory provision requiring loss causation.[403]

*Stock price rebound following price decline after disclosure of truth does not necessarily defeat loss causation*. In *Acticon AG v. China North East Petroleum Holdings Ltd.*,[404] the Second Circuit held that a trial court should not grant a motion to dismiss simply because the issuer's stock price rebounded[405] after falling upon publication of what plaintiffs claim to be the corrective disclosure in the case.[406]

403. *See infra* notes 422–48 and accompanying text.

404. 692 F.3d 34 (2d Cir. 2012).

405. The following table shows the dates of the public statements the Second Circuit references, *id*. at 36, and the closing prices of the issuer on surrounding trading days, Yahoo!Finance, http://finance.yahoo.com/q/hp?s=CNEP&a=01&b=22&c=2010&d=08&e=15&f=2010&g=d (last visited Jan. 15, 2013).

| Date | Event | Closing Price |
|---|---|---|
| 2/22/10 | | 9.77 |
| 2/23/10 | Issuer states that it is withdrawing 2008 and 2009 financial statements | 9.37 |
| 2/24/10 | | 8.68 |
| 2/25/10 | | 8.73 |
| 2/26/10 | | 9.23 |
| 3/1/10 | | 9.71 |
| 4/14/10 | | 9.85 |
| 4/15/10 | Issuer announces delay in filing 10-K | 9.10 |
| 4/16/10 | Issuer states it faces NYSE delisting and has internal control deficiencies | 8.71 |
| 4/19/10 | | 8.08 |
| 4/20/10 | Issuer revises estimated earnings downward due to misevaluation of oil and gas properties | 8.66 |
| 4/21/10 | | 8.57 |
| 4/22/10 | | 8.58 |
| 4/23/10 | | 8.78 |
| 4/26/10 | | 8.83 |
| 5/25/10 | | 5.20 |
| 5/26/10 | | 5.50 |
| 5/27/10 | Issuer announces that NYSE has halted trading in its stock as of 5/25 | |
| 9/9/10 | NYSE trading resumes | 4.42 |
| 9/10/10 | | 4.69 |
| 9/13/10 | | 5.14 |
| 9/14/10 | | 5.57 |
| 9/15/10 | | 5.31 |

406. A court can take judicial notice of publicly reported stock prices in ruling on a Rule 12(b)(6) motion. *See* Ganino v. Citizens Utilities Co., 228 F.3d 154, 166 n.8 (2d Cir. 2000).

The Second Circuit reasoned that "the fact . . . the price rebounded does not, at the pleading stage, negate the plaintiff's showing of loss causation" because "[a]t this stage in the litigation, we do not resolve why [the issuer's] share price rose after its initial fall and instead, drawing all reasonable inferences in favor of [the plaintiff], assume that the price rose for reasons unrelated to its initial drop."[407]

*Significance and analysis*. The *Acticon* decision seems right in that any of a number of factors could cause the price of a stock to increase on the trading day following the day on which the price declined due to the revelation of company-specific bad news. For example, the market as a whole might rise on the second of those two days or the stocks in the issuer's industry might rise on that second day—suggesting that the price increase was due not to market re-evaluation of the company-specific bad news but, respectively, to good news for stocks generally or to good news for the industry generally. The Second Circuit's decision, however, includes a confusing discussion of the bounce-back damage limitation in the Exchange Act,[408] in which the appellate court found the trial court's ruling on loss causation to conflict with that damages limitation.[409] Damages and loss causation, however, are separate elements,[410] and interpreting one by reference to the other can breed misunderstanding.[411]

*Expert's failure to control for obvious confounding factors contributing to stock price decline defeats proof of loss causation*. The plaintiffs in *Hubbard v. BankAtlantic Bancorp, Inc*. brought a Rule 10b-5 case against a defendant bank holding company and its management, alleging that they misrepresented the level of risk in commercial real estate loans made by the holding company's bank operating subsidiary.[412] After a jury returned a verdict partially in favor of the plaintiff, the trial court granted a defense motion for judgment as a matter of law.[413] The Eleventh Circuit affirmed on the ground that the plaintiff had failed to introduce evidence on which a reasonable jury could have found loss causation.[414]

The plaintiff's expert had examined the drops in the holding company's stock price after two disclosures related to the allegedly concealed risk.[415] To control for the influence of factors that were not specific to the bank, the expert used an event study employing (i) the S&P 500 Index to remove "any portion of the price

407. *Acticon*, 692 F.3d at 39–40.

408. *Id*. at 38–39 (quoting 15 U.S.C. § 78u-4(e)(1)).

409. *Id*. at 39.

410. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005) (listing loss causation and economic loss as separate elements); Miller v. Asensio & Co., 364 F.3d 223, 229–33 (4th Cir. 2004) (plaintiff can prove loss causation without being able to prove damages).

411. Not only did the Second Circuit devote words to the bounce-back, it also observed that its "holding [on loss causation] does not alter or abandon the traditional out-of-pocket measure for damages . . . , under which damages 'consist[ ] of the difference between the price paid and the "value" of the stock' when purchased." *Acticon*, 692 F.3d at 40 (quoting Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 168 (2d Cir. 1980)).

412. 688 F.3d 713, 715–16 (11th Cir. 2012).

413. *Id*. at 716.

414. *Id*. at 725, 730.

415. *Id*. at 722 (stating that the expert opined on the stock drops on April 26, 2007, and October 26, 2007).

declines attributable to market-wide factors" and (ii) the NASDAQ Bank Index "[t]o remove the effect of industry-specific factors."[416] She found that most of the decline after the first disclosure and the entire decline after the second disclosure were attributable to the fraud.[417] But her methodology "failed . . . to account for the effects of the collapse of the Florida real estate market,"[418] a risk of which the defendants *had* warned.[419] Accordingly, the plaintiff's evidence did not "exclude[] the possibility that class members' losses resulted not from anything specific about [the bank operating subsidiary's] commercial real estate portfolio that [the bank holding company] hid from the public, but from market forces that it had warned of—and that would likely have caused significant losses for an investor in any bank with a significant credit portfolio in commercial real estate in Florida in 2007."[420] The defendants were therefore "entitled to judgment as a matter of law."[421]

*Significance and analysis*. The *Hubbard* decision shows the searching analysis to which courts will subject expert testimony on loss causation. Even with a jury finding in favor of the plaintiff, the court tossed the entire case on the basis that a loss causation study—although it concededly *did* control for gross confounding factors—did not take account of market developments in the particular geographic market in which the defendant operated.

*Relationship between statutory requirement to prove loss causation and rescission remedy in Rule 10b-5 case*. The plaintiffs in *Nolfi v. Ohio Kentucky Oil Corp*. sued to recover for fraud on an investor who put money into a series of oil and gas ventures that drilled 128 wells, 117 of which were dry holes.[422] The plaintiffs claimed that the defendants "touted the virtues of the drilling joint-ventures and included grandiose promises of rich rewards, promises not tempered by cautions or warnings that the exploratory drilling [Ohio Kentucky] planned had a low chance of success—less than 10% and sometimes less than 5%."[423] A jury found in plaintiffs' favor on a Rule 10b-5 claim and determined that rescission damages totaled $7,700,723, but awarded only $1,777,090.[424] On appeal, the Sixth Circuit rejected the defense argument that the trial court should not have instructed on

416. *Id*. at 721–22. The court held that where a plaintiff relies on a stock drop to show loss causation and damages, the plaintiff must "offer evidence sufficient to allow the jury to separate portions of the price decline attributable to causes unrelated to the fraud, leaving only the part of the price decline attributable to the dissipation of the fraud-induced inflation." *Id*. at 726. While a "precise apportionment" of the decline between that part caused by revelation of the truth about the fraud and that part caused by non-fraud factors is not required to prove loss causation but is required to prove damages, "if there are confounding factors that could account for much of the decline in the price of the security, the plaintiff must offer *some evidence* separating the various causes of the decline in the security's price even to establish loss causation." *Id*. (emphasis added).

417. *Id*. at 722.

418. *Id*. at 729.

419. *Id*. at 729 & n.29.

420. *Id*. at 730.

421. *Id*.

422. 675 F.3d 538, 542 (6th Cir. 2012). The plaintiffs included the trustee of a trust that the investor had established and the executrix of his estate.

423. *Id*. at 543.

424. *Id*. at 544, 551.

rescission damages at all because the PSLRA's addition to the Exchange Act specifically requires a plaintiff in a Rule 10b-5 case to prove that all losses were caused by the defendants' conduct.[425]

Acknowledging that where a stock trades in a market a plaintiff typically shows loss causation by a decline in stock price when the truth behind a fraud comes out,[426] the court held that "[a] private sale of worthless investments by a company intending to keep the profits by drilling dry wells is in no way analogous to the public sale of stock by a major corporation."[427] Here, the misrepresentations "caused the complete loss of plaintiffs' entire investment because the wells were worthless, and the investments were fraudulent."[428] Since the plaintiffs "established that the loss was complete and was caused entirely by defendants' misrepresentation[s]," the trial court did not abuse its discretion by including a rescission theory in its jury instructions.[429] The Sixth Circuit found "nothing in the PSLRA that would make rescissory damages inappropriate for the circumstances of this case" and that "since the misrepresentations caused plaintiffs to lose their entire investment, rescission appears to be the only truly adequate remedy."[430] But the court added that "rescission is a fact-dependent remedy for § 10(b) claims and is likely only appropriate in rare or unusual circumstances."[431] And the Sixth Circuit affirmed the $1,777,909 judgment because the plaintiffs had failed to timely challenge the jury's seeming inconsistency in awarding only that amount after finding that rescission damages totaled more than $7,700,000.[432]

In *Strategic Diversity, Inc. v. Alchemix Corp.*, the Ninth Circuit, too, wrestled with the relationship between rescission and the statutory loss causation requirement.[433] The individual plaintiff (Kenneth Weiss or "Weiss") claimed that his investment company ("Strategic," also a plaintiff) had purchased stock in Alchemix at a discount price—in exchange for (i) accepting prepayment by Alchemix of a note given to Strategic, (ii) waiver of Strategic's right to loan additional money to Alchemix, (iii) modifying an antidilution provision in a warrant from Alchemix to Strategic, and (iv) agreement that Weiss would resign from the Alchemix board.[434] Weiss's Rule 10b-5 claim asserted he was misled into this complicated transaction by fraudulent statements that, if Weiss made all of the concessions involved in the deal, another investor would put $36 million into Alchemix.[435]

425. *Id.* at 550.
426. *Id.* at 549–50; *see supra* note 400 and accompanying text.
427. *Nolfi*, 675 F.3d at 550.
428. *Id.*
429. *Id.*
430. *Id.*
431. *Id.*
432. *Id.* at 551–52. To explain the difference between the two amounts, the court suggested that the jury had relied on an instruction permitting it "to compute damages based on the losses proximately caused by defendants' fraud—a measure that does not require rescissory damages." *Id.* at 551.
433. 666 F.3d 1197, 1207–09 (9th Cir. 2012).
434. *Id.* at 1202–04.
435. The appellate opinion is vague, but the district court's opinion makes this clear. Strategic Diversity, Inc. v. Alchemix Corp., No. CV-07-929-PHX-GM, 2010 WL 94122, at *4–5 (D. Ariz. Jan. 5, 2010).

The Ninth Circuit reversed summary judgment for defendants on the Rule 10b-5 claim because the district court had granted the judgment on the basis that Weiss produced no evidence of damages.[436] The court of appeals rejected Weiss's contention that he "need not have shown economic loss because he sought rescission and not damages."[437] Instead, the court held that the statutory requirement for loss causation meant that "rescission does not alleviate the burden of producing evidence of economic loss."[438] Much like the Sixth Circuit had done in *Nolfi*, the Ninth Circuit in *Strategic Diversity* held that rescission, or a rescission measure of damages if actual rescission is not possible,[439] may be available to the "victim of fraudulent inducement."[440] The court remanded for consideration of such relief here, but cautioned that Weiss would still have to prove loss causation, by "demonstrat[ing] that had he known . . . the truth" about the supposed $36 million investment, he would not have bought the Alchemix stock in exchange for, among other things, relinquishing the note from Alchemix to Strategic.[441]

*Significance and analysis*. The standard measure of Rule 10b-5 damages is out-of-pocket loss, measured, in a case where the plaintiff purchased the security, as the difference between the price the plaintiff paid and the value of the security at that time.[442] As the Sixth Circuit put it in *Nolfi*, the alternative rescission damages are "likely only appropriate in rare or unusual circumstances."[443] But the conditions making rescission right are hard to define. *Nolfi* emphasized that the oil and gas investments were worthless.[444] But *Strategic Diversity* made no statement that the Alchemix shares were valueless at the time Weiss acquired them. Instead it characterized a rescission as appropriate in a case of "fraudulent inducement."[445] A plaintiff, however, always must prove in a Rule 10b-5 case that he or she purchased while relying on the falsehood or omission, with this element sometimes called "transaction causation" and requiring that a plaintiff show that he or she would not have bought absent the fraud.[446] *Strategic Diver-*

436. *Strategic Diversity*, 666 F.3d at 1207–09, 1211. The court also vacated the judgment below so that the district court could consider the effect of new Supreme Court authority on the trial court's other ground for granting judgment to the defendants—that the Rule 10b-5 claim was barred by the statute of limitations. *Id.* at 1205–06.

437. *Id.* at 1207.

438. *Id.*

439. The court explained that "'[r]escission reverses the fraudulent transaction and returns the parties to the position they occupied prior to the fraud." *Id.* (quoting Ambassador Hotel Co. v. Wei-Chuan Inv., 189 F.3d 1017, 1031 (9th Cir. 1999)). Here, completely unwinding the transaction and returning the parties to their pre-deal positions was impossible, as the note that was prepaid had expired, there was no Alchemix board on which Weiss could take a seat, and "true rescission would also involve the unfurling of security interests that are currently held as collateral on other debts." *Id.* at 1208. But it might still be possible to award rescissionary damages to Weiss, measured by return to him of consideration paid minus any value that he received from the investment. *Id.*

440. *Id.*

441. *Id.* at 1209.

442. 2 Loss, Fundamentals, *supra* note 129, at 1676.

443. *Nolfi*, 675 F.3d at 550.

444. *See* text accompanying *supra* notes 427–29.

445. *See* text accompanying *supra* note 440.

446. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

*sity* has this proof—of the reliance element—also suffice as proof of loss causation when the plaintiff seeks rescission.[447]

Both *Nolfi* and *Strategic Diversity* involved fact-to-face transactions, so perhaps rescission is appropriate only when a transaction is off market. Or perhaps a plaintiff simply chooses rescission or out-of-pocket as the damages sought based on which one will yield the highest recovery.[448] But these vagaries aside, the statutory loss causation requirement has not buried rescission in Rule 10b-5 cases. And plaintiffs seeking that rescission damages will have to prove some kind of loss causation, even if that element—in a rescission case—simply mimics the reliance element.

**Manipulation**: *defendant's disclosures of its actions in the market, and the effect of those actions on market prices and liquidity, defeated action for manipulation.*

*Wilson v. Merrill Lynch & Co.* addressed a claim under Rule 10b-5(a) and (c) for manipulation of the market for auction rate securities ("ARS").[449] ARS are securities "traded through periodic auctions."[450] At any given auction, each holder of a security can decide to hold, sell, or buy "at particular interest rates or in particular quantities."[451] The liquidity of the ARS, and their interest rate, depends on whether the auctions succeed or fail.[452]

Merrill had submitted its own bids, in auctions of ARS for which Merrill served as a dealer, in order to prevent those auctions from failing.[453] In February 2008, Merrill and other dealers stopped submitting such supporting bids in ARS auctions, leading to auction failures and ARS illiquidity.[454]

Plaintiff—who had in July 2007 purchased ARS for which Merrill was a dealer—sued Merrill, alleging that Merrill had manipulated the market for the securities.[455] Before the plaintiff bought, Merrill had (as a result of a 2006

447. *See* text accompanying *supra* note 441.

448. *See* 2 Loss, Fundamentals, *supra* note 129, at 1676.

449. 671 F.3d 120, 127–28, 129 (2d Cir. 2011). Rule 10b–5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> . . . or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2012).

450. *Wilson*, 671 F.3d at 123.

451. *Id.*

452. *Id.* at 123–24 (explaining auctions and consequences of auction failure "[w]hen the number of shares offered for sale exceeded the number of shares bid for purchase").

453. *Id.* at 124.

454. *Id.*

455. *Id.* (date of purchase). The ARS litigation against Merrill had included two suits, which were consolidated in the trial court. *Id.* at 126. As part of a settlement with regulators, Merrill agreed to repurchase certain ARS at par, which the lead plaintiffs in one of the consolidated lawsuits accepted. *Id.* at 127. After those named plaintiffs withdrew and new lead plaintiffs were added, the

SEC order) posted on its website a fairly extensive set of disclosures of its ARS bidding practices.[456] In those disclosures, Merrill said that (i) it was "permitted, but not obligated, to submit orders in auctions for its own account either as a bidder or a seller, or both, and routinely does so in its sole discretion"; (ii) those bids were intended "to prevent an auction failure . . . or an auction from clearing at a rate that Merrill Lynch believes does not reflect the market for the securities"; (iii) those bids were "likely to affect the clearing rate, including preventing the clearing rate from being set at the maximum rate or otherwise causing bidders to receive a higher or lower rate than they might have received had Merrill Lynch not bid"; (iv) as a result of Merrill's bids, "the fact that an auction clears successfully does not mean that an investment in the securities involves no significant liquidity or credit risk"; (v) Merrill was "not obliged to continue to place such bids"; (vi) "[t]here [might] not always be enough bidders to prevent an auction from failing in the absence of Merrill Lynch bidding"; (vii) "[t]herefore, auction failures are possible, especially if the issuer's credit . . . deteriorate[d], if a market disruption . . . occur[red] or if, for any reason, Merrill Lynch [was] unable or unwilling to bid"; and (viii) accordingly, "[i]nvestors should not assume that Merrill Lynch will [continue to place supporting bids] or that auction failures will not occur."[457]

Affirming the district court's dismissal of the complaint,[458] the Second Circuit held that a manipulation claim under Rule 10b-5(a) and (c) "'require[s] a showing that an alleged manipulator engaged in market activity aimed at deceiving investors as to how other market participants have valued a security.'"[459] The PSLRA requires that a private plaintiff plead facts to raise a strong inference of the scienter as to such deception.[460] The plaintiff contended that Merrill engaged in such deception because it failed to disclose that (i) it had submitted support bids "in every single auction in which it was the sole or lead auction dealer under a tacit or express understanding with the issuers . . . that Merrill would systematically support the auction rate securities market"; (ii) "knew with certainty that there was insufficient investor demand, and that the market would fail unless it placed support bids"; (iii) "bid not out of a desire to increase its own inventory, but rather to create a false impression of demand"; and (iv) its "bids were not designed to 'reflect the market' for [Merrill] ARS, but to sustain it, as Merrill

litigation continued—on a manipulation theory under Rule 10b-5(a) & (c)—on behalf of ARS purchasers not eligible for the repurchase offer. *Id.*

456. *Id.* at 126–27.

457. *Id.* at 125–26.

458. *Id.* at 128, 140.

459. *Id.* at 130 (quoting ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 100 (2d Cir. 2007)). The court also quoted *Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999), in which the court said that: "The gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators." *Wilson*, 671 F.3d at 130.

460. *Id.* at 129. For a summary of the PSLRA pleading requirements, see *supra* notes 322–28 and accompanying text.

increased interest rates to attract buyers, in a desperate attempt to keep the market afloat for as long as possible."[461]

The appellate court found that Merrill's disclosure that it "may routinely" place bids was "not inconsistent with the possibility that it would place such bids in every Merrill ARS auction that took place over a particular period" and an intention "to place support bids in every single auction unless it decided to let certain auctions fail or withdraw from the market altogether."[462] The complaint failed to allege Merrill's knowledge that auctions would fail at the time the plaintiff bought (July 2007) but rather alleged that Merrill realized the market was "'unsustainable'" in "'the fall of 2007 . . . [after] the credit market had deteriorated, and Merrill and other dealers had allowed some ARS auctions to fail."[463] As to the allegations that Merrill failed to disclose that Merrill placed its bids to create a false impression of demand and to sustain the ARS market as long as possible, the court responded:

> Given Merrill's statements that it believed itself to be at liberty to engage in this market activity and its discussion of the possible consequences of this activity on the price and liquidity of ARS, its alleged motivations for placing support bids and its internal assessment of the viability of the ARS market do not render the disclosed practices manipulative.[464]

Summing up, the Second Circuit "h[e]ld that Merrill's disclosures of its bidding practices preclude Wilson's market manipulation claim."[465]

*Significance and analysis*. Three points bear emphasis. First, the Merrill disclosures that defeated the manipulation claim were posted on Merrill's website.[466] These were relevant because the plaintiff did "not claim that he directly relied on any statement attributable to Merrill."[467] Accordingly, the question was "whether Merrill's support bidding sent a false signal to the Merrill ARS market as a whole," a matter to which website disclosures might be relevant.[468] The Second Circuit emphasized, however, that it was *not* holding that "website disclosures like those here . . . may categorically immunize ARS dealers from claims that their bidding practices were manipulative, regardless of what the dealer knew and communicated to investors about its bidding practices and the securities' liquidity."[469] Second, the SEC (at the Second Circuit's invitation[470]) filed a letter

461. *Id.* at 131 (quoting plaintiff's brief).
462. *Id.* at 133.
463. *Id.* at 134.
464. *Id.* at 135. The Second Circuit duplicated the result in *Wilson* in a later case—*Anschutz Corp. v. Merrill Lynch & Co.*, 690 F.3d 98 (2d Cir. 2012). That case rejected a claim even though the plaintiff made one purchase before the broker's website disclosure began, on the ground that the plaintiff continued to hold during ARS auctions after that disclosure was posted. *Id.* at 110.
465. *Wilson*, 671 F.3d at 140.
466. *Id.* at 125–26.
467. *Id.* at 136.
468. *Id.*
469. *Id.* at 136 n.9.
470. *Id.*

brief in which it took the plaintiff's side.[471] This seems a bit cheeky, given that Merrill's disclosures were at the instance of an SEC enforcement proceeding completed in 2006.[472] That proceeding ended with a settlement imposing a number of disclosure obligations.[473] Arguably, the SEC should have been checking the disclosures made under that agreement and required more, if more were needed. Third, when defendants move to dismiss a manipulation claim on the basis that the defendants' disclosures prevented any deception, the defense needs to show those disclosures to the district court. Doing so may require judicial notice of publicly available material including websites—which notice the Second Circuit approved in another ARS case last year.[474]

**Class Actions**: *purchaser of mortgage-backed certificates based on mortgages held by one trust can represent class of purchasers of certificates backed by mortgages held by another trust where the fraud consists of misrepresentations about underwriting standards employed by identified financial institutions that originated mortgages held by both trusts; such a purchaser can represent those who bought certificates from different tranches.*

The plaintiff in *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.* bought mortgage-backed certificates from GS Mortgage Securities Corp.[475] The plaintiff sought to represent a class consisting of all who had purchased certificates in seventeen different offerings, with the underlying mortgages held by seventeen different trusts, each one of which held its own pool of mortgages.[476] The certificates were sold under one "base" shelf registration, with a prospectus supplement for each offering, so that the registration statement for each offering consisted of the base registration statement and the relevant supplement.[477] The certificates in each offering were sold out of various "tranches," so that purchasers of certificates in different tranches held different rights to the interest and principal payments from the underlying mortgage pool and therefore bought investments with different "risk profiles."[478] The trusts held mortgages originated by several financial institutions, and the plaintiff sued under sections 11 and 12(a)(2) of the Securities Act, claiming that the registration statements and prospectuses for the offerings misrepresented that the originators had adhered to underwriting standards designed to insure that the borrowers would be able pay on the mortgages.[479]

471. *Id.* at 137.
472. *Id.* at 125–26.
473. *In re* Bear Stearns & Co., Inc., Securities Act Release No. 8684, 88 SEC Docket 259 (May 31, 2006).
474. Finn v. Smith Barney, 471 F. App'x 30 (2d Cir. 2012).
475. 693 F.3d 145, 149 (2d Cir. 2012), *cert. denied*, 81 U.S.L.W. 3512 (U.S. Mar. 18, 2013) (No. 12-528).
476. *Id.* at 149 (identifying the defendants and explaining the chain of transactions leading to the offerings).
477. *Id.* at 150–51.
478. *Id.* at 150.
479. *Id.* at 149–52.

The plaintiff bought certificates issued against the pools of mortgages held by only two of the trusts, and the district court dismissed the plaintiff's complaint, giving it leave to amend to seek to represent a class limited to those (i) who had purchased certificates issued against the mortgages held by *those* two trusts and (ii) within that set, only those who had purchased certificates from the same tranches as the plaintiff.[480] In vacating the judgment to the extent that it so limited the suit,[481] the Second Circuit distinguished between a plaintiff's standing to pursue a claim in its own right and "class standing."[482] The plaintiff in this case had Article III and statutory standing to sue in its own right for recovery based on the misrepresentations in the sale of the particular certificates it bought.[483] The plaintiff's "class standing," however, did "not turn on whether [the plaintiff] would have statutory or Article III standing to seek recovery for misleading statements" in all the certificates purchased by class members[484] but on whether the plaintiff "plausibly alleges (1) that [it] 'personally has suffered some actual . . . injury as a result of the putatively illegal conduct of the defendant,' and (2) that such conduct implicates 'the same set of concerns' as the conduct alleged to have caused injury to other members of the putative class by the same defendants."[485]

While the plaintiff's claims rested in part on allegations that the mortgage industry as a whole had abandoned mortgage underwriting criteria during the run-up to the financial crisis, the plaintiff also included particularized allegations of underwriting abuse at identified mortgage originators.[486] Two of those originators—Greenpoint Mortgage Funding, Inc. ("Greenpoint") and Wells Fargo Bank ("Wells")—originated mortgages included in the pools behind the certificates that the plaintiff purchased *and* mortgages included in the pools held by five other trusts.[487] After commenting that "proof would center on whether the particular originators of the loans backing the particular Offering from which a Certificate-holder purchased a security had in fact abandoned its underwriting guidelines,"[488] the court held that the plaintiff had class standing to represent purchasers of certificates backed by any of the trusts holding mortgages originated by Greenpoint or Wells—i.e., the two trusts issuing the certificates the plaintiff had bought, and the five additional trusts.[489] The Second

480. *Id.* at 154–55.
481. *Id.* at 168.
482. *Id.* at 158.
483. *Id.*
484. *Id.*
485. *Id.* at 162 (quoting, first, Blum v. Yaretsky, 457 U.S. 991, 999 (1982) and, second, Gratz v. Bollinger, 539 U.S. 244, 267 (2003)).
486. *Id.* at 152, 163–64.
487. *Id.* at 163–64.
488. *Id.* at 163. It was sufficient that *some* of the loans in the other trust pools were made by those originators. *Id.* at 164 ("Based on the allegations . . . , those Trusts include the GSAA Home Equity Trust 2007-3 (29% GreenPoint-originated loans), 2007-4 (36% GreenPoint-originated loans), 2007-6 (9% GreenPoint-originated loans), and 2007-7 (23% GreenPoint-originated and 67% Wells Fargo-originated loans) and the GSR Mortgage Loan Trust 2007-3F (47% Wells Fargo-originated loans).").
489. *Id.* at 164.

Circuit held further that the plaintiff's class standing extended to the purchasers in all tranches of the offerings backed by pools containing mortgages originated by Greenpoint or Wells because the different tranches did not raise "'fundamentally different set[s] of concerns.'"[490] Instead, "[r]egardless of their level of subordination, each Certificate-holder within an Offering . . . backed by loans originated by similar lenders has the same 'necessary stake in litigating' whether those lenders in fact abandoned their underwriting guidelines."[491]

*Significance and analysis*. In 2011, the First Circuit held that purchasers of mortgage-backed certificates bringing section 11 and section 12(a)(2) claims sufficiently alleged misleading statements about originator underwriting standards because the plaintiffs identified a "key" originator of loans in trusts backing the certificates the plaintiffs purchased and alleged specifically that *that* originator had deviated from the represented underwriting standards.[492] But the First Circuit found allegations of unprofessional appraisal practices inadequate because the plaintiff made only industry-wide charges that banks pressured appraisers to produce false values and failed to assert that "any specific bank that supplied mortgages to the trusts" holding the mortgages behind the certificates the plaintiffs bought had "exert[ed] undue pressure, let alone that such pressure had succeeded."[493] With pleadings focused in this way on identification of specific originators in mortgage securitization cases based on inadequate underwriting, the Second Circuit's class standing protocol in *Goldman Sachs* seems workable.[494]

**Miscellaneous Cases**: *location of closing, or location of action by which parties are bound to a sale, can determine whether U.S. securities law applies to a transnational securities transaction*; *court can certify Rule 23(b) settlement class in Rule 10b-5 action without finding that the class could show fraud-on-the-market reliance*; *no § 10(b) claim for alleged hypothecation of securities where case rested on brokerage account customer agreements that appeared to permit use of customer securities for broker's secured financing; plaintiffs suing under ICA § 36(b) cannot prevail simply by showing that an investment advisor did not deal fairly in fee negotiations with the investment company; Sarbanes-Oxley whistleblower protection does not extend to employees of an issuer's contractors and subcontractors.*

In addition to the cases reviewed in the categories above, the courts of appeals authored more opinions in 2012 worth mention. The Ninth Circuit held that the territorial reach of the Securities Act in transactions not involving exchange-

490. *Id.* (quoting *Gratz*, 539 U.S. at 264).

491. *Id.* (quoting Blum v. Yaretsky, 457 U.S. 991, 999 (1982)).

492. Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp., 632 F.3d 762, 772–74 (1st Cir. 2011).

493. *Id.* at 774.

494. In *Nomura* itself, the First Circuit limited the plaintiffs to bringing a class action against the defendants involved in the two trusts whose certificates the plaintiffs bought, *id.* at 769–71, on the theory that "[e]ach trust is backed by loans from a different mix of banks; no named plaintiff has a significant interest in establishing wrongdoing by the particular group of banks that financed a trust from which the named plaintiffs made no purchases," *id.* at 771. The *Nomura* panel did not consider the extension of "class standing" to claims for purchasing certificates based on mortgages held by different trusts but originated by a named financial institution that plaintiffs specifically allege to have abandoned underwriting standards.

traded securities can be determined by the location of a deal's closing,[495] and the Second Circuit ruled that the territorial reach of Rule 10b-5 can be determined in such transactions by the place at which the parties became irrevocably committed to a deal or where title to the securities passes.[496] The Second Circuit held that a court could certify a Rule 23(b)(3) class for settlement purposes even if the lead plaintiff could not show classwide reliance through a fraud on the market.[497] In a case arising from Refco's demise, the Second Circuit found no Rule 10b-5 fraud—in light of customer account agreements—in a broker's hypothecation of customer securities in transactions providing secured financing to the broker.[498] In a case where plaintiffs claimed that an investment adviser violated its fiduciary duty to charge only reasonable fees, the Eighth Circuit—in light of recent Supreme Court precedent—retreated from its position that an adviser can violate section 36(b) by unfair conduct in fee negotiations even if the resulting fees are not excessive.[499] Finally, the First Circuit held that the whistleblower protection in Sarbanes-Oxley does not extend to the employees of contractors for public companies.[500]

*Location of closing, or location of an action that irrevocably commits a party to a securities transaction, can determine applicability of antifraud provisions of federal securities law*. In *Morrison v. National Australia Bank, Ltd.*, the Supreme Court held that section 10(b) of the Exchange Act "reaches the use of a manipulative or deceptive device or contrivance only in connection with [i] the purchase or sale of a security listed on an American stock exchange, and [ii] the purchase or sale of any other security in the United States."[501] The Eleventh Circuit subsequently held that the second basis for jurisdiction is satisfied if a non-exchange traded security is sold in a transaction that *closes* in the United States.[502] The Ninth Circuit reached the same conclusion in a case involving the Securities Act.[503]

Also addressing the second basis that *Morrison* identified to define the territorial reach of the securities law, the Second Circuit held last year, in a Rule 10b-5

495. *See infra* notes 501–03 and accompanying text.
496. *See infra* notes 504–09 and accompanying text.
497. *See infra* notes 510–18 and accompanying text.
498. *See infra* notes 519–31 and accompanying text.
499. *See infra* notes 532–37 and accompanying text.
500. *See infra* notes 538–41 and accompanying text.
501. 130 S. Ct. 2869, 2888 (2010).
502. Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC, 645 F.3d 1307, 1310–11 (11th Cir. 2011) (per curiam).
503. SEC v. Levine, 462 F. App'x 717, 719 (9th Cir. 2011) ("the Securities Act governs the Levines' sales because the actual sales *closed* in Nevada when Marie Levine received completed stock purchase agreements and payments" (emphasis added)). *Levine* was an SEC enforcement action, arising out of events in 2004 and 2005. *See* Brief of Appellee Securities and Exchange Commission, SEC v. Levine, 462 F. App'x 717, 719 (9th Cir. 2011) (No. 10-16238). After *Morrison*—and long after the events in *Levine*—Congress effectively reversed *Morrison* as it applies to SEC enforcement actions by reinstating, for those actions, the "conduct" or "effects" test that *Morrison* supplanted. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 929P(b), 124 Stat. 1376, 1862 (2010) (codified at 15 U.S.C. § 77v(c); 15 U.S.C. 78aa(b) (2006 & Supp. V 2011)); Marc I. Stein & Kelly Flanagan, *Transnational Dealings*— Morrison *Continues to Make Waves*, 46 INT'L LAW. 829, 836–37 (2012). Accordingly, *Levine* provides an interpretation of *Morrison* that remains useful for private actions, but will not govern future SEC enforcement efforts.

case, that the sale of an unlisted security occurs "in the United States" as *Morrison* used that phrase if "irrevocable liability was incurred or title was transferred within the United States."[504] In adopting that rule, the court rejected (i) the "suggest[ion] that the location of the broker-dealer should be used to locate securities transactions";[505] (ii) the assertion that transactions are domestic under *Morrison* if "the securities are issued by United States companies and are registered with the SEC";[506] (iii) the idea that the residences of the buyer and seller should determine application of the securities law;[507] and (iv) the contention that any given defendant must have "engaged in conduct within the United States" in order that the defendant be pursued on an Exchange Act claim.[508] The Second Circuit then affirmed dismissal of the Rule 10b-5 claim because the complaint did not include facts showing transfer of title in the United States or any action in this country that bound the parties to the sale.[509]

*Class certification for settlement purposes possible without a finding of class reliance*. Rule 23(b)(3) authorizes certification of a class where, among other things, "the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy."[510] The Rule then adds that the "matters pertinent to these findings" include "the likely difficulties in managing a class action."[511] In a Rule 10b-5 misrepresentation case, where plaintiffs must prove reliance, a court typically cannot certify a Rule 23(b)(3) class unless the plaintiffs can show that the security traded in an efficient market, the misrepresentation affected the market price at which all class members bought or sold, and all class members therefore presumptively relied on the misrepresentation by buying or selling at that fraud-infected price (the "fraud-on-the-market presumption").[512] On the motion to

504. Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 64–65, 68 (2d Cir. 2012).

505. *Id.* at 68 (acknowledging "that the location of the broker could be relevant to the extent that the broker carries out tasks that irrevocably bind the parties to buy or sell securities," but concluding that "the location of the broker alone does not necessarily demonstrate where a contract was executed").

506. *Id.* at 68–69 (reasoning that *Morrison* "refers to 'domestic transactions in other securities [that is, other than those traded on U.S. exchanges],' *Morrison*, 130 S. Ct. at 2884, not 'transactions in domestic securities' or 'transactions in securities that are registered with the SEC'").

507. *Id.* at 69 (quoting Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co., 753 F. Supp. 2d 166, 178 (S.D.N.Y. 2010) (concluding that "'[a] purchaser's citizenship or residency does not affect where a transaction occurs; a foreign resident can make a purchase within the United States, and a United States resident can make a purchase outside the United States'")).

508. *Id.* (noting that this view was too close to the "conduct and effects" test that *Morrison* refused to adopt).

509. *Id.* at 70 (ruling that it was insufficient "[a]bsent factual allegations . . . including, but not limited to, facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money" to allege "mere[ly] that transactions 'took place in the United States,'" or that defendants resided in the United States or that they engaged in fraudulent conduct in this country).

510. Fed. R. Civ. P. 23(b). Such a class must also satisfy the requirements of Rule 23(a). *Id.*

511. Fed. R. Civ. P. 23(b)(3)(D).

512. Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2184–85 (2011); Basic Inc. v. Levinson, 485 U.S. 224, 229–30, 241–50 (1988).

certify a Rule 23(b)(3) class in such a case, plaintiffs must demonstrate "that the [security] traded in an efficient market."[513]

Last year, the Second Circuit considered whether a district court could certify a *settlement* class under Rule 23(b)(3) without such a demonstration.[514] The court reasoned that manageability and predominance of common questions were not separate inquiries but were linked so that "the existence of a settlement that eliminates manageability problems can alter the outcome of the predominance analysis."[515] Thus, with a settlement, there will be no need for either "the extremely laborious—and often impossible—task of proving at trial that each individual plaintiff was aware of and specifically relied upon the defendant's false statement"[516] or "rebuttal [of a reliance presumption that] could demonstrate that individual reliance issues would render a trial unmanageable."[517] Accordingly, the court held that "a Section 10(b) settlement class's failure to satisfy the fraud-on-the-market presumption does not necessarily preclude a finding of predominance" and that "[w]here a Section 10(b) *settlement* class would otherwise satisfy the predominance requirement, the fact that the plaintiff class is unable to invoke the presumption, without more, is no obstacle to certification."[518]

*No section 10(b) claim for allegedly inappropriate hypothecation of securities in brokerage accounts*. Brokerage customers of Refco Capital Markets, Ltd. ("RCM") sued former officers of, and the accountant for, RCM on the ground that RCM had hypothecated securities in the customers' accounts.[519] The Second Circuit affirmed dismissal of this Rule 10b-5 case.[520] The court held that the "gravamen" of the claim was a "breach of contract."[521] Such a breach cannot support a Rule 10b-5 claim unless "the breaching party never intended to perform its material obligations under the contract."[522] Pleading such a case requires either (i) alleging a breach of such "a character that [the breach] alone provides 'strong circumstantial evidence' of an intent to deceive at the time of contract formation" or (ii) alleging "particularized facts supporting a 'cogent and compelling' inference of that intent."[523] Since the plaintiffs included no such particularized facts in

513. *Halliburton*, 131 S. Ct. at 2185.
514. *In re* Am. Int'l Grp., Inc. Sec. Litig., 689 F.3d 229, 241–43 (2d Cir. 2012).
515. *Id.* at 242.
516. *Id.* at 241.
517. *Id.* at 242.
518. *Id.* at 242–43 (emphasis added).
519. Capital Mgmt. Select Fund Ltd. v. Bennett, 680 F.3d 214 (2d Cir. 2012).
520. *Id.* at 224–25, 234. The Second Circuit decision repeatedly refers to "rehypothecation." *See, e.g.*, *id.* at 220, 222. Technically, *re*hypothecation occurs when a brokerage client hypothecates securities to the broker in exchange for credit extended from the broker to the client, and the broker then *re*hypothecates those same securities to a third party in exchange for credit extended from the third party to the broker. As set out in the text, the clients in *Capital Management* complained that RCM had hypothecated—for its own financing—securities in the clients' accounts that were *not* serving as collateral for loans from RCM to the clients—i.e., securities that the clients had *not* hypothecated to RCM.
521. *Id.* at 225.
522. *Id.* at 226.
523. *Id.*

their complaint, the case rested on whether the brokerage Customer Agreements set out obligations so clear that the failure to meet them led to a strong inference that Refco never intended to do so.[524]

Under the Customer Agreements, RCM had certain rights to use securities in non-discretionary customer accounts as security for loans *to RCM* from third parties.[525] The Customer Agreements provided that, when RCM extended margin financing, the customer granted RCM "a first priority, perfected security interest in all of [the customer's] cash, securities and other property (whether held individually or jointly with others) and the proceeds thereof from time-to-time in the possession or under the control of" RCM and its affiliates.[526] The Agreements also provided that, "until settlement in full of all" margin financing extended to the customer, "[RCM] shall have the right to loan, pledge, hypothecate or otherwise use or dispose of such cash, securities and other property free from any claim or right."[527] The customers contended that "they were deceived into believing" that RCM would not hypothecate—for RCM's own financing—any securities in the customers' accounts except the securities that were actually serving as collateral for margin loans extended to the customers.[528]

The Second Circuit therefore found the "crux of the issue" to be "whether RCM's rehypothecation of securities even when they were not deemed collateral was so inconsistent with the provisions of the Customer Agreement that the Agreement was itself a deception."[529] The Second Circuit found no such deception as the language of the Customer Agreement gave RCM a right to hypothecate "all of [a client's] cash, securities and other property" at any time that RCM extended margin financing of any amount—"even a dime"—to the customer.[530] Hence, there was "no disparity between the provisions of the Customer Agreement and RCM's conduct remotely supportive of a claim that the Agreement was a misrepresentation actionable under Section 10(b)."[531]

*Successful suit under ICA section 36(b) requires proof that fees charged lie outside the range of fees from arm's length bargaining, with evidence that the advisor did not act fairly in fee negotiations not by itself sufficient*. In 2009, the Eighth Circuit reversed summary judgment for an advisor to mutual funds sued for violation of ICA section 36(b), with the court holding that an adviser to an investment company could violate the fiduciary duty imposed by that section simply by unfair conduct in fee negotiations—even if the fees resulting from the negotiations

524. *Id.*
525. *Id.* at 220–21, 227 n.16 (quoting section of Customer Agreement making accounts non-discretionary).
526. *Id.* at 227 (quoting Customer Agreement § B.1).
527. *Id.* (quoting Customer Agreement § B.2).
528. The plaintiffs referred to these other securities—which were not serving as collateral for margin loans—as "excess margin" or "fully-paid" securities. *Id.* at 226; *see id.* at 222 (defining "excess margin securities," as "securities not deemed collateral to secure a customer's outstanding margin debt," and "fully-paid securities," as "securities in a cash account for which full payment has been made").
529. *Id.* at 226–27.
530. *Id.* at 228.
531. *Id.* at 229.

were not excessive.[532] In 2010, the Supreme Court held in *Jones v. Harris Associates L.P.* that "to face liability under § 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[533] The Court further held that "the Act instructs courts to give [the investment company's] board['s] approval of an adviser's compensation 'such consideration . . . as is deemed appropriate under all the circumstances,'"[534] with the degree of that deference depending on such variables as "'the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the [investment adviser's] service and fee, and the extent of care and conscientiousness with which [the trustees] perform their duties.'"[535] After the Supreme Court then vacated the 2009 Eighth Circuit decision, the district court in that case granted summary judgment again, and the Eighth Circuit affirmed that judgment in 2012.[536] This time around, the court of appeals held that "after *Jones*, a process-based failure alone does not constitute an independent violation of § 36(b)."[537]

*Employees of contractors and subcontractors to public companies not covered by SOX whistleblower protection*. The Sarbanes-Oxley Act of 2002 prohibited any company registered under section 12 of the Exchange Act or required to file reports by section 15(d) of that act from "discharg[ing], demot[ing], suspend[ing], threaten[ing], harass[ing], or in any other manner discriminat[ing] against an employee" who "provide[s] information . . . or otherwise assist[s] in an investigation" of wire or mail fraud or any violation of the securities laws or regulations that is being conducted by "a Federal regulatory or law enforcement agency," "any Member of Congress or any committee of Congress," or any supervisor.[538] The prohibition extended to "any officer, employee, contractor, subcontractor, or agent of such company."[539] In *Lawson v. FMR LLC*, the First Circuit ruled that this protection covers only the employees of publicly traded companies,

532. Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 822–24 (8th Cir. 2009).

533. 130 S. Ct. 1418, 1426 (2010).

534. *Id.* at 1428 (quoting 15 U.S.C. § 80a-35(b)(2)).

535. *Id.* (quoting *Gartenberg*, 694 F.2d at 930).

536. Gallus v. Ameriprise Fin., Inc., 675 F.3d 1173, 1178, 1182 (8th Cir. 2012).

537. *Id.* at 1179. The court added that flaws in the process by which a mutual fund board approved fees could be taken into account in deciding how much deference to give to the board's decision to agree to the fees. *Id.* at 1180. But *Jones* "instruct[s] that § 36(b) 'is sharply focused on the question of whether the fees themselves were excessive.'" *Id.* at 1179 (quoting *Jones*, 130 S. Ct. at 1430).

In a second ICA section 36(b) case, the Third Circuit held that a plaintiff must retain, throughout the lawsuit, his or her interest in the investment vehicle being advised by the defendant. Santomenno v. John Hancock Life Ins. Co. (U.S.A.), 677 F.3d 178, 182–85 (3d Cir.), *cert. denied*, 133 S. Ct. 529 (2012).

538. SOX, *supra* note 243, § 806, 116 Stat. at 802 (codified at 18 U.S.C. § 1514A (2006)). The coverage now extends not only to the employees of the publicly traded companies but also to the employees of "any subsidiary or affiliate whose financial information is included in the consolidated financial statements of such company" and to employees of "nationally recognized statistical rating organization[s]." 18 U.S.C. § 1514A(a).

539. 18 U.S.C. § 1514A(a).

not to the employees of contractors to those companies.[540] The reference to "any officer, employee, contractor, subcontractor, or agent of such company" in the statute simply identifies those who cannot retaliate against the employee of the public company who engages in the protected whistleblowing, but does not enlarge the set of persons entitled to whistleblower protection.[541]

540. 670 F.3d 61, 68 (1st Cir. 2012) ("We conclude that only the employees of the defined public companies are covered by these whistle-blower provisions.").

541. *Id.* at 68–69. The panel split two to one. *Id.* at 83–93 (Thompson, J., dissenting).