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# SDNY ISSUES SPLIT DECISION IN *SEC v. RIPPLE LABS*, POTENTIALLY COMPLICATING ANALYSIS OF WHEN CRYPTO-TOKENS WILL BE TREATED AS SECURITIES

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On July 13, 2023, Judge Analisa Torres in the Southern District of New York issued the much-anticipated summary judgment order in the Securities and Exchange Commission's ("SEC") case against Ripple Labs and two senior leaders, Bradley Garlinghouse and Christian Larsen.[1] The decision granted and denied in part both the SEC's and Ripple's cross-motions for summary judgment, leaving only the relatively narrow question of the individual defendants' alleged role in Ripple's violations unresolved.

Judge Torres' decision is the latest in a recent line of district court opinions examining, in the context of actions brought by the SEC, when digital assets should be treated as securities under the Supreme Court's "*Howey* test," as articulated in *SEC v. W.J. Howey Co.*[2] Indeed, *Ripple* relied on language from each of *SEC v. Telegram Group, Inc.*; *SEC v. LBRY, Inc.*; and *SEC v. Kik Interactive Inc.* in explaining how Ripple's XRP tokens should be treated under the *Howey* test.[3]

*Ripple* is not a clean victory for the SEC or the crypto-industry, and may very well be appealed by either or both sides. Indeed, much of Judge Torres' opinion leaves considerable room for interpretation, not only as to what tokens might be deemed to be securities subjecting certain transactions to registration requirements, but also regarding in what contexts such token transactions will constitute investment contracts. As such, market participants should be cautious in relying solely on the *Ripple* decision when contemplating future transactions. Nevertheless, *Ripple* is an important addition to the caselaw interpreting *Howey* in the crypto asset context and warrants close attention.

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## Background

As described by Judge Torres, Ripple is a company that "seeks to modernize international payments by developing a global payments network for international currency transfers." The XRP Ledger Ripple utilizes aims to be a "faster, cheaper, and more energy-efficient alternative to the bitcoin blockchain." XRP is the digital token of the XRP Ledger. Pursuant to the XRP source code, there is a fixed supply of 100 billion XRP—each of which is divisible into one million sub-units called "drops." Ripple itself held 80 billion of the 100 billion XRP at launch.

The SEC's case against Ripple focuses on three categories of XRP sales Ripple conducted over the years. First, Ripple sold XRP "directly" to "institutional buyers, hedge funds," and "on demand liquidity" customers ("Institutional Sales"). Second, Ripple sold XRP on "digital asset exchanges" through trading algorithms "programmatically" ("Programmatic Sales"). Third, Ripple used XRP as payment for certain services ("Other Distributions"). These services included employee compensation and software developers to build new applications for XRP and the XRP Ledger.

## Decision

Judge Torres' ruling focused on several key issues: (1) whether Ripple's XRP token was inherently a security; (2) whether Ripple's Institutional Sales of the XRP token constituted securities transactions; and (3) whether Ripple's Programmatic Sales of XRP on exchanges and Other Distributions for employees and service providers constituted securities transactions.

### *A. First, the Court ruled that XRP Tokens are not inherently securities*

To determine whether XRP tokens are securities—defined under the Securities Act as including any "investment contract"—the Court applied the Supreme Court's test in *SEC v. W.J. Howey Co.*, which defines an investment contract as a contract, transaction, or scheme whereby a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits solely from the efforts of the promoter or a third party. As a threshold matter, the Court explained that the relevant question is not simply whether XRP tokens are securities for all purposes, but whether they can serve as the subject of an investment contract under the *Howey* test in the specific contexts presented to the Court. Judge Torres noted that many cases applying the *Howey* test have found that both tangible and intangible assets can serve as the subject of an investment contract even when that asset was "not itself inherently an investment contract." Gold, silver, and sugar, for instance, are

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considered "ordinary assets," but in certain contexts, they may serve as the asset underlying investment contracts.

Here, the Court found XRP "is not in and of itself a contract, transaction, or scheme," but rather just a "digital token," that was not in and of itself an investment contract. That does not mean, however, that certain XRP transactions could not constitute investment contracts—and therefore, under *Howey*, securities. The Court thus embarked on a factspecific analysis of whether the Institutional Sales, Programmatic Sales, and Other Distributions of XRP constituted investment contracts subject to the Securities Act's registration requirements.

### *B. Second, the Court found that Ripple's Institutional Sales constituted investment contracts*

The Court granted the SEC's summary judgment motion regarding Ripple's Institutional Sales, holding that those direct institutional XRP sales to investors constituted an unregistered offer and sale of investment contracts. This ruling continued the trend in *Telegram*, *Kik*, and *LBRY*, holding that certain sales of digital tokens can constitute securities transactions, and again highlighted that such determinations are highly dependent on the specific facts and circumstances of the token sales at issue.

***Howey* analysis.** Per the Court, Ripple's Institutional Sales met each *Howey* prong. As to whether the transaction included an "investment of money," the Court found that the "payment of money" to Ripple for XRP established this element. Regarding the second prong, the "existence of a common enterprise," the Court ruled that there was "horizontal commonality" between Ripple and investors, as Ripple "pooled the proceeds" together and used them to "finance its operations." Each institutional buyer's "ability to profit was tied to Ripple's fortunes" (and the fortunes of other buyers) because all "received the same fungible XRP."

The Court held that these sales met the third *Howey* prong as well, reasoning that sophisticated institutional buyers purchased XRP "with the expectation that they would derive profits from Ripple's efforts." In support of that finding, the Court catalogued Ripple's "many" statements and messaging about "the investment potential of XRP and its relationship" to Ripple's efforts. As we noted following the *LBRY* decision, such statements appear to attract considerable attention from the SEC and, the caselaw suggests, from courts.[4]

Notably, Judge Torres refused to apply the "essential ingredients" test *Ripple* had advanced to avoid the impact of the *Howey* test (at least as the Court interpreted the *Howey* test). The Court described the essential ingredients test as focusing on post-sale obligations for the seller to generate a return and a right for the investor to share in profits, but called it a "novel" test that no court had ever applied. In other words, *Howey's* focus on expectation of profits from the efforts of others was enough; one need not inquire into post-sale obligations.

Despite ruling against Ripple Labs as to Institutional Sales, it found the record did not support granting the SEC summary judgment on its aiding and abetting claims against the individual defendants, claims that require proof that the individuals "knew, or recklessly disregarded, the facts that made Ripple's transactions and schemes illegal under statutory and case law" and that they substantially assisted those violations. This underscores the challenges the SEC faces in charging individuals whose knowledge and assistance of underlying violations will often be more difficult to resolve at the summary judgment stage.

**Due process objections.** The Court similarly declined to endorse Ripple's or the individuals' defenses of "fair notice" and "vagueness" based on due process principles. The Court explained that any evaluation of a fair notice defense is objective, not specific to whether Ripple or the individual actually received a warning alerting them to the danger of being held to account for their behavior. It then held that *Howey* "sets forth a clear test" for determining what constitutes an investment

contract, and that its "progeny provides guidance on how to apply that test to a variety of factual scenarios." The Court further found that the SEC's "approach to enforcement, at least as to" the institutional sales, was "consistent[.]"

### *C. Third, the Court found that Ripple's Programmatic Sales on exchanges and Other Distributions (to employees and service providers) were not securities transactions*

**Programmatic sales on exchanges.** Judge Torres held that Ripple's Programmatic Sales of XRP through "digital asset exchanges" did not establish the third *Howey* prong—*i.e.*, that a reasonable expectation of profits be derived from the entrepreneurial or managerial efforts of others. The Court, finding these programmatic buyers did not know to whom or what they were paying money, held that Ripple's transactions with them did not constitute offers and sales of investment contracts. The SEC argued that Ripple "explicitly targeted speculators," but this failed. Per the Court, "a speculative motive" from the purchaser or seller was not sufficient to "evidence the existence of an 'investment contract'[.]" Even if purchasers expected profit, this expectation was not derived from "Ripple's efforts."

In reaching its conclusion, the Court explained that Ripple's Programmatic Sales did not include contracts with "lockup provisions, resale restrictions, indemnification clauses, or statements of purpose," and noted the "less sophisticated" nature of programmatic buyers, who were less likely to have an understanding and expectation that XRP would grow in value based on Ripple's efforts.[5] The Court also noted the relatively small proportion of global XRP trading volume found to be Ripple's programmatic sales. Here again, the Court's factspecific analysis should give observers pause before drawing broad conclusions about what this or other courts might find rises to the level of an investment contract for transactions in other crypto assets.

In a related holding, the Court also found that Larsen's and Garlinghouse's sales on digital asset exchanges also were not securities transactions for largely the same reasons.

**Other Distributions of XRP as compensation and payment for services.** The Court also found that XRP token distributions to employees and third parties to develop software for the XRP ecosystem were not offers and sales of investment contracts. Here, the Court held that the SEC could not meet its burden as to the first *Howey* prong because recipients of Other Distributions did not pay money to Ripple. The Court noted that *Howey* requires a showing that investors "provided the capital" or "put up their money." Judge Torres' decision rejects the proposition that labor—from employees or third parties who developed applications for XRP and the XRP Ledger—constituted tangible and definable consideration to Ripple.

### *D. Where does the industry go from here?*

On the heels of SEC victories in *Telegram*, *Kik*, and *LBRY*, the *Ripple* decision offers some reasons for optimism for crypto market participants that, under certain circumstances, transactions in crypto tokens will not be subject to federal registration requirements. Observers should be cautious to avoid treating any pronouncements in *Ripple* as gospel, however, as the decision (which is still subject to appeal) was careful to emphasize the specific facts driving its conclusions, leaving ample room for different holdings where token issuers present different factual contexts.

- **Tokens as inherent securities.** Regarding whether digital assets are in and of themselves securities, the Court's factual analysis suggests that not every digital asset transaction may be a securities offering. Like gold, silver, and sugar, tokens may sometimes be ordinary assets. As such, they may be the subject of investment contracts in some contexts and fail the *Howey* test in others, leaving many unanswered questions about how a market in such tokens can function under current securities laws and SEC interpretations of those laws.

- **Institutional sales.** The Court's grant of the SEC's summary judgment motion as to Ripple's institutional sales, while also fact dependent, may


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raise questions about how token issuers, startups, and projects approach institutional investors. Some, like Ripple, do engage with sophisticated institutional investors to sell tokens in exchange for money. Depending on how this ruling plays out in the appeals process and is applied by other courts, regulators are likely to continue scrutinizing these practices.

- **Alternatives to *Howey* and due process defenses.** Perhaps the biggest "winner" in *Ripple* is the *Howey* test itself. Often criticized as a poor fit to apply to digital assets, Judge Torres reaffirmed the test's applicability to the current digital landscape in rejecting the "essential ingredients" test and in holding that *Howey* sets forth a clear test for what constitutes an investment contract—and its progeny provide guidance as to how to apply the *Howey* test—in a manner that is sufficient to satisfy due process. Those looking for new rules to apply to determine what constitutes an investment contract may need to rely on Congressional action.

- **Programmatic sales on exchanges.** It is difficult to view this portion of the ruling as providing a clear opening for token issuers and projects to make their tokens available via exchanges in every instance, given the fact-intensive nature of the Court's analysis. Further, the Court expressly declined to address the question of whether indirect secondary sales constitute securities transactions. Many eyes are on this issue—something both the Judge Torres here and the court in the recent *LBRY* case declined to reach.

- **Token compensation and services payments.** Many projects compensate their employees with tokens. It is also common practice in the industry for crypto projects to compensate engineers with tokens for developing software for a particular blockchain ecosystem. The Court's ruling on this issue appears favorable to the industry, though the decision left ample room for a different result where facts relating to such compensation may differ. Individual projects and organizations will need to do a careful analysis of their own compensation and payment approaches while keeping a close eye on subsequent rulings.

In sum, although *Ripple* breaks new ground in several areas, clarity is still lacking for industry, regulators, and courts navigating the fast-changing tides of crypto and blockchain technology. As this and other cases progress through the pleadings, merits, and appeals stages, the market must continue to be ready to adapt to new developments as it seeks more clarity from regulators and the courts.

## ENDNOTES:

[1]*Securities and Exchange Commission v. Ripple Labs, Inc.*, 2023 WL 4507900, at *1 (S.D. N.Y. 2023). (https://www.nysd.uscourts.gov/sites/default/files/2023-07/SEC%20vs%20Ripple%207-13-23.pdf.)

[2]*S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244, 163 A.L.R. 1043 (1946).

[3]*Securities and Exchange Commission v. Telegram Group Inc.*, 448 F. Supp. 3d 352, Fed. Sec. L. Rep. (CCH) P 100769 (S.D. N.Y. 2020); *Securities and Exchange Commission v. LBRY, Inc.*, Fed. Sec. L. Rep. (CCH) P 101502, 2022 DNH 138, 2022 WL 16744741, at *7 (D.N.H. 2022); *U.S. Securities and Exchange Commission v. Kik Interactive Inc.*, 492 F. Supp. 3d 169, 175-80 (S.D. N.Y. 2020).

[4]See https://www.mofo.com/resources/insights/221110-court-rules-lbry-token.

[5]Although many would have liked it to do so, the Court did not address the issue of whether secondary XRP sales constitute offers and sales of investment contracts. It noted that the outcome of such an analysis would "depend on the totality of circumstances and economic reality of t[he] specific contract, transaction, or scheme." *Ripple* at *23.

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# SEC ADOPTS RULES FOR CYBERSECURITY RISK MANAGEMENT, STRATEGY, GOVERNANCE AND INCIDENT DISCLOSURE

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On July 26, 2023, the U.S. Securities and Exchange Commission ("SEC") voted 3-2 to adopt final rules[1] that are intended to enhance and standardize disclosures regarding cybersecurity risk management, strategy, governance and incident reporting by public companies that are subject to the reporting requirements of the Securities Exchange Act of 1934 (including foreign private issuers). Specifically, the SEC's amendments require:

- Current reporting of material cybersecurity incidents.
- Annual reporting of company processes for identifying, assessing and managing material risks from cybersecurity threats; management's role in assessing and managing the company's material cybersecurity risks; and the board's oversight of cybersecurity risks.

## Key Requirements of Cybersecurity Incident Disclosure Rules

### *Form 8-K Trigger*

The final rules amend Form 8-K to add new Item 1.05, which requires disclosure within four business days after a company determines that a "cybersecurity incident" experienced by the company is material. The trigger for Item 1.05 of Form 8-K is the date on which the company determines that a cybersecurity incident it has experienced is material, rather than the date of discovery of the incident itself. An instruction to Form 8-K provides that materiality determinations must be made "without unreasonable delay" after discovery of a cybersecurity incident, and the SEC states in the adopting release that "adhering to normal internal practices and disclosure controls and procedures will suffice to demonstrate good faith compliance."

### *Materiality*

The SEC also explains in the adopting release that the analysis for materiality of cybersecurity incidents is the same as the materiality analysis for other securities laws purposes, and that the analysis should take into account qualitative and quantitative factors in assessing materiality.

### *Required Disclosure*

In the event disclosure is triggered, a company must describe:

- The material aspects of the nature, scope and timing of the incident.
- The material impact or reasonably likely material impact on the company, including its financial condition and results of operations.
- An instruction to Form 8-K clarifies that companies do not need to disclose specific or technical information about the company's planned response to the incident or its cybersecurity systems in such detail as would impede the company's response or remediation of the incident.

The SEC did not adopt the proposed rule that would have required companies to disclose in their periodic reports any material changes, additions or updates to a prior disclosure under Item 1.05 of Form 8-K or any individually immaterial cybersecurity incidents not previously disclosed that become material in the


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aggregate. The adopting release highlighted, however, that the definition of "cybersecurity incident" is intended to be construed broadly and includes "a series of related unauthorized occurrences." As a result, it is possible that Item 1.05 could be triggered by a series of related occurrences that are deemed material in the aggregate.

### *Delay Due to Risks to National Security or Public Safety*

A company may delay disclosure of a material cybersecurity incident for up to 30 days if the U.S. Attorney General determines that disclosure poses a substantial risk to national security or public safety. The disclosure may be delayed for an additional period of up to 30 days if the Attorney General determines that disclosure continues to pose a substantial risk. In extraordinary circumstances, in the case of risk to national security, disclosure may be delayed for a final additional period of up to 60 days. It remains to be seen what processes the U.S. Department of Justice will establish to consider delayed disclosure.

Companies that are subject to the Federal Communications Commission's ("FCC") notification rule for breaches of customer proprietary network information ("CPNI") may delay making the Form 8-K disclosure up to seven business days following notification to the U.S. Secret Service and the Federal Bureau of Investigation, as specified by the FCC rule.

### *Updating Disclosure*

In the event that information required to be disclosed under Item 1.05 of Form 8-K is not determined or is unavailable at the time of the required filing, companies must note the missing information in the initial disclosure and file an amendment to Form 8-K within four business days after such information is determined or becomes available.

There is no specific requirement to provide updated information concerning a cybersecurity incident, either in a Form 8-K or in a company's periodic reports. The SEC noted in the adopting release, however, that companies may have a duty to correct prior disclosure that they determine was untrue at the time it was made or a duty to update disclosure that becomes materially inaccurate after it was made.

## Cybersecurity Risk Management, Strategy and Governance Disclosure

### *Risk Management*

New Item 106(b) of Regulation S-K requires a description of the company's processes, if any, for assessing, identifying and managing material risks from cybersecurity threats in sufficient detail for a reasonable investor to understand those processes. The rule provides the following nonexclusive list of potential disclosure items:

- Whether and how the described processes have been integrated into the company's overall risk management system or processes.
- Whether the company engages assessors, consultants, auditors or other third parties in connection with any such processes.
- Whether the company has processes to oversee and identify material risks from cybersecurity threats associated with its use of third-party service providers.

In addition, Item 106(b) requires companies to describe whether any risks from cybersecurity threats, including as a result of any previous cybersecurity incidents, have materially affected or are reasonably likely to materially affect the company, including its business strategy, results of operations or financial condition, and if so, how.

### *Governance*

New Item 106(c) of Regulation S-K requires companies to disclose information related to the board's and management's roles relating to cybersecurity.

With respect to the board of directors, companies must describe:

- The board's oversight of risks from cybersecurity threats and, if applicable, any board committee or subcommittee responsible for such oversight.
- The processes by which the board or board committee is informed about such risks.

Notably, the SEC did not adopt the proposed rule that would have required companies to disclose the cybersecurity expertise, if any, of the company's board members.

With respect to management, companies must describe management's role in assessing and managing the company's material risks from cybersecurity threats. The rule provides the following nonexclusive list of potential disclosure items:

- Whether and which management positions or committees are responsible for assessing and managing such risks, and the relevant expertise of such persons or members in such detail as is necessary to fully describe the nature of the expertise.
- The processes by which such persons or committees are informed about and monitor the prevention, detection, mitigation and remediation of cybersecurity incidents.
- Whether such persons or committees report information about such risks to the board of directors or a board committee or subcommittee.

### *Disclosure by Foreign Private Issuers*

Amendments to Forms 20-F establish disclosure requirements for foreign private issuers parallel to those adopted for domestic issuers in Regulation S-K Item 106. Amendments to Form 6-K also parallel those adopted for domestic issuers in Form 8-K Item 1.05, and require foreign private issuers to furnish on Form 6-K information about material cybersecurity incidents that the issuers disclose or otherwise publicize in a foreign jurisdiction, to any stock exchange or to security holders.

### *Inline XBRL Tagging*

The adopted rules require reporting companies to tag disclosure under Item 1.05 of Form 8-K and Item 106 of Regulation S-K using Inline XBRL, with a staggered compliance date of one year beyond initial compliance with the disclosure requirements.

## Compliance Dates

- Companies other than smaller reporting companies must begin complying with current reporting of material cybersecurity incidents (on Form 8-K or Form 6-K, as applicable) on the later of 90 days after the date of publication of the final rules in the Federal Register or December 18, 2023.
- Smaller reporting companies will have an additional 180 days and must begin complying with Form 8-K reporting of material cybersecurity incidents on the later of 270 days from the effective date of the rules or June 15, 2024.
- Companies must include the cybersecurity risk management, strategy and governance disclosures in their annual reports for fiscal years ending on or after December 15, 2023.
- As noted above, companies will have an additional year after the initial compliance dates for tagging the disclosure using Inline XBRL.

For additional information on the new rules, see the press release announcing adoption of the final rules[2] and the fact sheet published by the SEC.[3]

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**ENDNOTES:**

[1]*See* https://www.skadden.com/-/media/files/publications/2023/07/sec-adopts-rules-for-cybersecurity-risk-management/final-rules.pdf.

[2] https://www.sec.gov/news/press-release/2023-139.

[3] https://www.skadden.com/-/media/files/publications/2023/07/sec-adopts-rules-for-cybersecurity-risk-management/fact-sheet-published-by-the-sec.pdf.

## ECJ CLARIFIES CONDITIONS UNDER WHICH MEMBER STATES CAN BLOCK FOREIGN DIRECT INVESTMENTS

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**The Situation**: On July 13, 2023, the European Court of Justice ("ECJ") issued a judgment (Case C-106/22—*Xella*) clarifying the conditions under which EU Member States may screen and block foreign direct investments.

**The Background:** Over the past few years, EU Member States have strengthened their national Foreign Direct Investment ("FDI") screening mechanisms and blocked an increasing number of transactions by non-EU investors. The ECJ's decision imposes restrictions on EU Member States on the way they design their FDI screening mechanisms as well as on the arguments they can bring forward to justify blocking decisions.

**Looking Ahead:** EU Member States will have to check to which extent their FDI screening mechanisms comply with the guidance issued by the ECJ. They will face uphill battles in case they want to block acquisitions of EU companies by EU-based companies only because these EU-based acquirers have non-EU shareholders. The ECJ will ensure that EU Member States only block transactions in these cases if there is a genuine and sufficiently serious threat affecting a fundamental interest of society.

In another case relating to foreign direct investment control in Hungary,[1] the ECJ clarified the conditions under which EU Member States may screen and block foreign direct investments. The ECJ held that Regulation (EU) 2019/452 ("EU Screening Regulation") does not apply to investments performed by an EU-based company even if it is (directly or indirectly) controlled by non-EU shareholders. The freedom of establishment granted by Art. 49 of the Treaty on the Functioning of the European Union ("TFEU"), the ECJ continued, protects an EU-based company that wants to buy another EU-based company even if such EU acquirer has non-EU shareholders. According to the ECJ, any restriction of this freedom needs to be justified by legitimate reasons of public interest (inter alia to ensure security and the continuity of supply "as regards basic social needs") and must be appropriate and necessary for the protection of such interest.

While the ECJ acknowledges that Member States remain free to determine the requirements of public policy and public security, these requirements need to be interpreted strictly and their application by EU Member States is subject to the control by the EU's

institutions. As regards the specific facts of the case at hand, the ECJ held that the goal to secure the supply of local construction companies with basic raw materials does not justify a blocking decision. The ECJ further concluded that the required "real and sufficient serious threat" is unlikely to exist in a case where the foreign-controlled investor already purchased 90% of the target's production capacity in the past.

In the case for which the ECJ provided its preliminary ruling, the Hungarian government blocked the indirect acquisition of a company owning a quarry used for the extraction of construction aggregates (sand, gravel, and clay) by a U.S.-based private equity firm. The quarry's production of these materials accounts for less than 1% of Hungary's production of these aggregates. Ninety percent of the quarry's production is sold to the direct acquirer, which is a wholly-owned subsidiary of a German entity. The remainder is sold to Hungarian building companies.

According to the Hungarian government, its screening act is to prevent speculative investments in companies strategic to the Hungarian economy. It justified its blocking decision with the strategic importance of the extraction and supply of aggregates and with the need to protect a secure and foreseeable supply. If the quarry were to fall into foreign hands, Hungary argued, the long-term supply of building materials would be at risk.

Given that the direct acquirer in the case at hand is a Hungarian entity controlled by a U.S.-based private equity fund, a decisive question for the legal analysis is whether this entity can rely on the freedom of establishment provided by Art. 49 TFEU to EU-based entities or (only) on the free movement of capital protected by Art. 63 TFEU, which is also enjoyed by non-EU entities. According to the ECJ, the mere fact that an EU entity has non-EU shareholders is insufficient to consider such EU entity a non-EU investor with the consequence that such entity is protected by the freedom of the establishment. As such entity constitutes a "Union company" despite its foreign owners, the ECJ held, the EU Screening Regulation does not apply.

In a second step, the ECJ confirmed that Member States are allowed to restrict foreign direct investments to protect security and public order even if they are protected by a fundamental freedom. While noting that Member States are, in general, free to determine the requirements of public policy and public security, the ECJ held that these grounds must be understood restrictively and their scope cannot be determined unilaterally by an EU Member State without control by the EU institutions. In particular, the ECJ confirmed that public policy and public security can only be relied on in case there is a genuine and sufficiently serious threat affecting a fundamental interest of society. While the ECJ acknowledges that the objective of guaranteeing security of supply of certain products and services may constitute a reason of public security and may therefore justify a restriction of a fundamental freedom, it held that the aim of ensuring security of supply of aggregates for local construction companies does not qualify as a possible basis for a blocking decision. Furthermore, the ECJ expressed doubts whether the transaction blocked by Hungary may constitute a "real and sufficiently serious threat affecting a fundamental interest of society," noting that the direct acquirer of the target purchased already 90% of the target's production capacity in the past.

The relevance of the ECJ's decision, which certainly concerns a unique fact pattern, goes far beyond the case at hand.

Firstly, the fact that the ECJ held that companies that are constituted in accordance with the law of a Member State and that have their registered office, central administration, or principal place of business within the Union are EU companies that enjoy the freedom of establishment even if such companies have non-EU shareholders has far-reaching consequences for FDI screening mechanisms of EU Member States. This is because—in case of an acquisition of a local target by a direct EU acquirer with non-EU shareholders—many of such mechanisms deem these non-EU shareholders to indirectly acquire the local target and consider themselves entitled to block the direct acquisition by

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the EU acquirer. A significant number of FDI screening mechanisms of EU Member States (or at least their application in practice) is therefore likely to violate EU law.

Secondly, the ECJ makes clear that Member States wishing to block transactions or to impose remedies must bring forward a legitimate aim and must ensure that any restriction is appropriate and necessary for the protection of a genuine threat to a fundamental interest of society. According to the decision, this test will be met only in limited fact patterns. Further, the decision makes equally clear that any blocking decisions by EU Member States are subject to a judicial review on the basis of EU law. The ECJ's decision therefore clearly strengthens the procedural position of acquirers in screening proceedings under national law and should facilitate legal remedies against government decisions blocking or restricting foreign direct investments.

### Four Key Takeaways

1. Companies constituted in accordance with the law of a Member State and having their registered office, central administration, or principal place of business within the Union are EU companies for FDI screening mechanism purposes even if they have non-EU shareholders. Because they can rely on the freedom of establishment when acquiring other EU companies, their transactions can only be blocked in very limited fact patterns.

2. FDI screening mechanisms of EU Member States as well as blocking decisions based thereon are subject to a judicial review on the basis of EU law. Any blocking decision requires a legitimate aim designed to protect against a genuine threat to a fundamental interest of society. According to the ECJ, restrictions of the right to invest in an EU undertaking need to be justified by legitimate reasons of public interest and need to be appropriate and necessary for the protection of such public interest.

3. The assessment of whether there is proportionality and an acceptable justification for a given restriction is subject to judicial review on the basis of EU law.

4. The ECJ's decision clearly strengthens the procedural position of acquirers in screening proceedings under national law and should facilitate legal remedies against government decisions blocking or restricting foreign direct investments.

*The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.*

**ENDNOTES:**

[1]*See* https://www.jonesday.com/en/insights/2022/03/ec-blocks-hungarys-veto-attempt-under-fdi-rules.

## SEC PROPOSES REFORMS FOR INTERNET ADVISERS EXEMPTION

On July 26, 2023, the SEC announced it was considering amendments to the existing rule that permits certain investment advisers that provide investment advisory services through the internet to register with the Commission.[1] Proponents of the amendments, including Chair Gary Gensler, claimed "they would modernize a 21-year-old rule to better protect investors in a digital age."

Investment advisers, depending on size and other characteristics, must register either with the SEC or with state securities regulators. In 1996, Congress divided the responsibility for regulating investment advisers—larger investment advisers with national presence would be regulated by the SEC while smaller advisers "with sufficient local presence" would be regulated by the states. "We have a good working relationship with these state regulators; the markets benefit from this efficient allocation of resources," Gensler said.

The issue, the SEC says, is that this law was enacted in what now seems like a prehistoric age, in terms of the internet. In 1996 there was no social media nor smartphones, relatively few users had access to broadband internet, and the concept of "online finance" was still obscure for much of the general public—electronic trading platforms like Globex and E-Trade had been around only for a handful of years. Only in 2002 did the SEC grant what was intended to be a narrow exception—the Internet Advisers Exemption—allowing internet-based advisers to register with the SEC instead of with the states.

As Commissioner Caroline Crenshaw noted in a statement on the amendments,[2] "though these advisers otherwise may not meet the statutory thresholds for registering with the Commission, the agency created a limited exemption for advisers who provide advice to their clients almost exclusively through an interactive website. But for this exemption, internet advisers who do not meet the statutory thresholds for registration with the Commission would likely incur the burdens of temporarily registering in multiple states and then later withdrawing, depending on the current makeup of their client base. As the proposing release points out, in the 20 years from its adoption through the end of 2022, 845 advisers have relied on the Internet Adviser Exemption as the basis for registration with the Commission, and the exemption has been used with increasing frequency in more recent years."[3]

The problem, Crenshaw said, "is that the exemption is being chronically misused. In 2021, staff observed that nearly half of the examined advisers relying on the Internet Adviser Exemption in fact did not meet the requirements of exemption. This was, in many instances, because they did not have an interactive website, or they had advisory personnel who could expand on the investment advice provided by their interactive website or provide other advice. Exam staff also observed many other points of non-compliance generally in the internet adviser space."[4]

"Thus, an exemption that was intended to be quite narrow has become broad—and broadly-misused—to the benefit of certain non-compliant advisers who may have avoided multiple state registrations and potentially used registration with the Commission to instill the imprimatur of agency approval," Crenshaw said.

"The proposal accounts for market developments, and the rise of robo-advisers, but nonetheless brings the Internet Adviser Exemption back into alignment with our statutory mandate and its regulatory purpose," she added.

Gensler, in his statement supporting the amendments, said "I believe an exemption written in 2002 allows gaps in 2023. In recent years, staff have observed compliance deficiencies by advisers relying on this exception."

The proposal would modernize the Internet Advisers Exemption in two ways, as per Gensler.[5]

"First, the proposal would require advisers seeking to rely on the Internet Advisers Exemption to have at all times an operational, interactive website through which the adviser provides digital investment advisory services on an ongoing basis to more than one client. That means, if the proposal is adopted, firms that rely on the Internet Advisers Exemption—thus being regulated by the SEC rather than state securities regulators—would actually need to advise clients through the internet, and do so from the moment the firms rely on this exception. The website cannot be used as a prop, akin to how a man behind the curtain used props to pretend to be the Wizard of Oz."

"Second, the proposal would require advisers seeking to rely on the Internet Advisers Exemption to provide advice to clients exclusively through this operational, interactive website. Currently, the rule allows advisers to qualify as internet advisers while, for instance, also serving a small number of investors in person, over the phone, or by other means."

"These changes would better reflect what it means in 2023 truly to provide an exclusively internet-based


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service. This would better align registration requirements with modern technology and help the Commission in the efficient and effective oversight of registered investment advisers," Gensler added.

Commissioner Hester Peirce, in a statement,[6] noted that "the internet adviser exemption is intended to provide a narrow path for otherwise ineligible investment advisers providing advice through the internet to register with the Commission. But the exemption is not working. As the Commission staff relayed in a 2021 Risk Alert, '[n]early half of the [examined] advisers claiming reliance on the Internet Adviser Exemption were ineligible to rely on the exemption, and many were not otherwise eligible for SEC-registration.' Many internet advisers have withdrawn their registrations, and the rate of withdrawals has been increasing."[7]

Peirce added, however, that she had some questions about the proposed amendments.

"The term 'digital investment advisory services,' the release explains, 'could include advice that is generated by software-based algorithms in addition to software-based models or applications.'[8] This proposed language, in itself, is not problematic, but it may become so in light of today's earlier proposal. What effect would we anticipate the Conflicts of Interest proposal, which would reach such technologies, having on advisers, particularly small advisers, seeking to use the internet exemption?"

Another of Peirce's questions: "One of the proposed requirements is that an adviser have a constantly operational website. Would the rule allow for temporary planned outages to implement software upgrades?"

The proposing release will be published in the Federal Register, and the public comment period will remain open until 60 days after the date of publication there.

**ENDNOTES:**

[1]Proposing Release, Exemption for Certain Investment Advisers Operating Through the Internet, Rel. No. IA- -6354 (July 26, 2023) ("Proposing Release").

[2] https://www.sec.gov/news/statement/crenshaw-statement-internet-advisors-072623.

[3]Proposing Release at 9.

[4]*See Observations from Examinations of Advisers that Provide Electronic Investment Advice* (Nov. 9, 2021) at 8.

[5] https://www.sec.gov/news/statement/gensler-statement-internet-advisors-072623.

[6] https://www.sec.gov/news/statement/peirce-statement-internet-advisors-072623.

[7]Proposing Release at 13 ("At the same time, the frequency of registration withdrawals and cancellations of internet investment advisers also has increased since the rule's adoption, which has affected the cumulative growth in the number of advisers relying on the exemption. For example, approximately 64 percent of the advisers withdrawing their registration under the rule have done so since 2017, while only approximately 36 percent of the withdrawing advisers did so from the rule's adoption in 2002 through 2016.").

[8]Proposing Release at 20 ("The proposed definition is designed to address that, like the current rule, an adviser must provide investment advice exclusively through an interactive website, but specify that the generation of such advice could include advice that is generated by software-based algorithms in addition to software-based models or applications, in each case, based on personal information each client supplies through the interactive website.").

## THE POTENTIAL PITFALLS OF PURPORTED CRYPTO "ASSURANCE" WORK

*By Paul Munter*

*Paul Munter is the chief accountant of the Securities and Exchange Commission. The following is edited from a statement that he released on July 27, 2023.*

Following the recent waves of scandal and insolvency in the crypto industry, there has been a renewed focus on the firms, including accounting firms, that have been retained by companies in the crypto-asset space—in particular, crypto asset trading platforms. Certain crypto asset trading platforms, with others in the crypto industry, have marketed to investors their

retention of third parties, sometimes accounting firms, to perform some sort of review of certain parts of their business, often presented as a purported "audit." As accounting firms increasingly engage in this sort of non-audit work, their clients' marketing and terminology risks misleadingly suggesting that these alternative, non-audit arrangements are at parity with, or even more "precise" than, a financial statement audit. Such suggestions are false. Non-audit arrangements are neither as rigorous nor as comprehensive as a financial statement audit, and may not provide any reasonable assurance to investors.

The hazards to investors associated with such characterizations have been publicized by the Commission staff, PCAOB staff,[1] and others. This statement is directed primarily to the accounting profession, including new entrants into non-audit service work for crypto asset clients. Accounting firms that choose to perform work in this space must keep several obligations and hazards front of mind.

## The Accounting Firm's Potential Liability for Antifraud Violations

As a threshold matter, an accounting firm should carefully consider the contents of any statements that it or its clients make about the scope of work performed and the nature of the procedures followed because material misstatements regarding those subjects could result in legal liability for the accounting firm. Such statements could implicate the antifraud provisions of the federal securities laws if there has been fraud "in the offer or sale" of a security (for purposes of Section 17(a) of the Securities Act of 1933) or "in connection with" the purchase or sale of a security (for purposes of Section 10(b) of the Securities Exchange Act of 1934), and if certain other requirements for liability are met. In addition, any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of the Securities Act or the Exchange Act, or of any rule or regulation issued thereunder, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.[2]

There could be a variety of facts and circumstances under which an audit firm whose client misrepresents the nature of the firm's services creates potential liability for antifraud violations. Where an accounting firm becomes aware that a client has made misleading statements to the public about the nature of its non-audit work, OCA staff believe that, as best practice, the accounting firm should consider making a noisy withdrawal, disassociating itself from the client, including by way of its own public statements, or, if that is not sufficient, informing the Commission.[3]

Accounting firms should consider such risks and responsibilities during their client acceptance procedures. Additionally, regarding non-audit clients who are new entrants to the crypto industry with no track record of such misrepresentations, the accounting firm may nonetheless wish to implement certain precautions. These may include, for example, contractual prohibitions on the ways in which the non-audit client can publicly describe a non-audit arrangement with the firm to ensure that investors are not misled into believing that the non-audit work provides assurance when it does not. In a similar vein, the accounting firm may consider including in its client acceptance letters limitations on misleading references to "audit," "GAAS," "PCAOB standards," and "PCAOB inspections."

## Auditor Independence

Particularly with respect to newer market entrants without established operating histories but which may pursue a registered public offering in the near term, we understand that accounting firms at times consider performing only limited, non-audit consultation services with an eye to accepting an audit engagement from such clients later on, after becoming sufficiently comfortable that a given client meets applicable ethical and competency requirements, among other considerations.[4] For any market participant seeking to register with the Commission, any preceding, non-audit engagements, and the accounting firm's conduct during those engagements require the accounting firm to assess whether it would meet applicable independence requirements if it accepted the audit engagement.[5]

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Rule 2-01 of Regulation S-X is designed to ensure that auditors are qualified and independent of their audit clients both in fact and appearance when performing an audit subject to the Commission's independence requirements. The Commission will consider all relevant facts and circumstances when making this determination, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission. As we have noted elsewhere, the general standard of independence in Rule 2-01(b) is the heart of the Commission's auditor independence rule.[6] It provides that an accountant is not independent of an audit client if "the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."[7]

In this regard, the Commission considers, among other things, whether a relationship or service creates a "mutual or conflicting interest between the accountant and the audit client" or "places the accountant in the position of being an advocate for the audit client."[8] Audit Firms and their associated entities must consider the effects that their non-audit services and relationships have on their ability to maintain independence, both in fact and appearance, when performing audits for audit clients and their affiliates.

Where an audit firm engages in advocacy or lobbying efforts on behalf of an audit client in the course of an audit subject to Commission or PCAOB rules, for example, a firm should consider its public statements or assertions to determine whether they could create a perception that there is a possible mutual interest between the audit firm, its audit client, and entities under common control or significant influence of the audit client, or whether the audit firm may be acting as an advocate for its audit client, such that a reasonable investor with knowledge of all relevant circumstances would conclude that the firm is not independent and capable of exercising objective and impartial judgment during an audit engagement.[9]

## Potential Liability Pursuant to Rule 102(e) of the Commission's Rules of Practice

An accounting firm's violation of the antifraud provisions of the federal securities laws or applicable independence requirements could result in the censure or suspension of the firm, or its accountants, from the privilege of appearing or practicing before the Commission as an accountant under Rule 102(e) of the Commission's Rules of Practice. Rule 102(e) was adopted as a means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties,[10] perform their tasks diligently and with a reasonable degree of competence.[11] Pursuant to Rule 102(e)(1), the Commission may censure or deny the privilege of appearing or practicing before it any person who is found, among other reasons, "[t]o be lacking in character or integrity or to have engaged in unethical or improper professional conduct," or "[t]o have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder."

As explained at Rule 102(e)(1)(iv), with respect to persons licensed to practice as accountants, "improper professional conduct" includes not only knowing or reckless conduct that violates applicable professional standards, including auditor independence standards, but also certain types of negligent conduct:

- a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted, or
- repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

Because of the importance of an accountant's independence to the integrity of the financial reporting system, the Commission has concluded that circumstances that raise questions about an accountant's inde-

pendence always merit heightened scrutiny, and so a single instance may merit sanctions under the rule.[12] And improper professional conduct by an accountant may create liability for the entire audit firm, which serves a critical gatekeeper function with respect to investor protection in the public interest.[13] No audit firm is too small, or too big, to be suspended from appearing or practicing before the Commission.

## Conclusion

We have emphasized on many occasions that accounting firms play a vital gatekeeper role. Clients and the investing public rely upon accountants to act as trusted third parties not only when conducting financial statement audits but also when providing other types of services. Maintaining the public's confidence is a serious responsibility, and it requires accountants to exercise integrity in their actions and activities. This includes ensuring that the accountants' names or services are not being used to convey a false sense of legitimacy or to mislead investors. It is difficult, if not impossible, to regain the public trust once it has been eroded, and therefore we are reminding accountants of their ongoing obligation to conduct their activities in a way that maintains, and ideally increases, public trust and confidence in the accounting profession.

## ENDNOTES:

[1]*E.g.,* SEC Office of Investor Education and Advocacy, Exercise Caution with Crypto Asset Securities: Investor Alert (Mar. 23, 2023), https://www.sec.gov/oiea/investor-alerts-and-bulletins/exercise-caution-crypto-asset-securities-investor-alert; Jean Eaglesham, SEC Heightening Scrutiny of Auditors' Crypto Work, Wall St. J. (Dec. 22, 2022), *available at* https://www.wsj.com/articles/sec-heightening-scrutiny-of-auditors-crypto-work-11671681693 (quoting SEC Chief Accountant Paul Munter). *See also E.g.,* PCAOB Office of the Investor Advocate, Investor Advisory: Exercise Caution With Third-Party Verification/Proof of Reserve Reports (Mar. 8, 2023), https://pcaobus.org/resources/information-for-investors/investor-advisories/investor-advisory-exercise-caution-with-third-party-verification-proof-of-reserve-reports.

[2]*See* Section 15(b) of the Securities Act, 15 U.S.C.A. § 77o; Section 20(e) of the Exchange Act, 15 U.S.C.A. § 78t.

[3]We believe that continuing to accept engagements while knowing the client is using the accounting firm to perpetrate a fraud is itself inherently misleading. An investor might reasonably assume, for instance, that an accounting firm would not permit a proof-of-reserves report that it prepared to be equated with a financial statement "audit" in its clients' marketing materials, and that such a firm should let it be known, if discovered, that such representations were incorrect or otherwise take adequate steps to disassociate itself from that client. We believe that it is not unreasonable to expect an accountant, who stands in a special relationship of public trust, and whose duty is to safeguard the public interest, to disclose such misrepresentations, particularly where the accountant's information is obviously superior to that of the investor, the cost to the accountant of revealing the information is minimal, and the cost to investors of the information remaining secret is potentially significant. *See, e.g*., AICPA Code of Professional Conduct 0.300.020 (noting accountants' continuing responsibility to exercise moral judgments and maintain the public's confidence), 0.300.030 (noting the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism), 0.300.040 (noting that accountants should perform all professional responsibilities with the highest sense of integrity, which includes being honest and candid). A majority of state boards of accountancy have adopted the AICPA Code of Professional Conduct within their state accountancy laws. AICPA & CIMA, 2022 State regulatory and legislative outlook, https://us.aicpa.org/content/dam/aicpa/advocacy/state/downloadabledocuments/56175896-state-reg-leg-outlook-for-2022.pdf.

[4]*E.g.,* PCAOB AS 2101: Audit Planning.

[5]*See, e.g*., 17 C.F.R. § 210.2-01; PCAOB AS 1005: Independence. The authority and jurisdiction of the Commission and the PCAOB is prescribed by statute, and such jurisdiction may not extend to all aspects of the crypto asset markets. For instance, the PCAOB's jurisdiction generally extends to audits (and related engagements) of issuers and certain broker-dealers registered with the Commission, and certain provisions of the federal securities laws over which the Commission has enforcement authority may be limited in their applicability to public companies or registered broker-dealers.

[6]*See, e.g*., Paul Munter, The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession (June 8, 2022).


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[7]*See* 17 C.F.R. § 210.2-01(b).

[8]17 C.F.R. § 210.2-01.

[9]Moreover, in the event the audit firm accepts the audit engagement, it should also keep front of mind its legal obligations under Section 10A of the Exchange Act, which requires audit firms to adopt procedures to detect illegal acts, among other things, in connection with their audits, and report to the issuer and if necessary to the Commission the illegal acts that the issuer committed.

[10]*See* Final Rule: Amendment to Rule 102(e) of the Commission's Rules of Practice, Release No. 33-7593 (Oct. 26, 1998), *available at* https://www.sec.gov/rules/final/33-7593.htm ("Investors have come to rely on the accuracy of the financial statements of public companies when making investment decisions. Because the Commission has limited resources, it cannot closely scrutinize every financial statement.[] Consequently, the Commission must rely on the competence and independence of the auditors who certify, and the accountants who prepare, financial statements. In short, both the Commission and the investing public rely heavily on accountants to assure corporate compliance with federal securities law requirements and disclosure of accurate and reliable financial information.").

[11]The rule addresses the conduct not only of accountants, but also of attorneys, engineers, and other professionals or experts who appear or practice before the Commission. 17 C.F.R. § 201.102(e)(2) and (f)(2).

[12]*See* Final Rule, supra note 12 ("Because of the importance of an accountant's independence to the integrity of the financial reporting system, the Commission has concluded that circumstances that raise questions about an accountant's independence always merit heightened scrutiny.").

[13]*See, e.g., In re Lester Witte & Co.*, Release No. 34-17423 (Jan. 7, 1981) (finding both partner and firm responsible for a deficient audit where they failed to meet professional standards).

## SEC/SRO UPDATE: SEC ADOPTS AMENDMENTS TO ENHANCE PRIVATE FUND REPORTING; SEC BRINGS FRAUD CHARGES AGAINST TRUMP-RELATED SPAC; SEC CHARGES OPERATOR OF COLLECTIBLES MARKETPLACE WITH OPERATING AN UNREGISTERED SECURITIES EXCHANGE; SEC PROPOSES AMENDMENTS TO THE BROKER-DEALER CUSTOMER PROTECTION RULE

*By John A. Elofson, Stephanie G. Danner, and Martine C. Ventello*

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## SEC Adopts Amendments to Enhance Private Fund Reporting

On May 3, 2023, the Commissioners of the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") voted to adopt final amendments (the "Amendments") to Form PF and Rule 204(b)-1 under the Investment Advisers Act of 1940 ("Advisers Act").[1] Form PF is the confidential reporting form used by certain advisers to private funds to report information to the SEC and the Financial Stability Oversight Counsel ("FSOC") about the private funds they manage.[2]

By way of background, the SEC adopted Form PF in 2011 after the enactment of the Dodd-Frank Wall Street Reform and Accountability Act of 2010 (the "Dodd-Frank Act"), which directed the SEC to collect information about private funds for use by the FSOC to help in its assessment of systemic risk in the financial system.[3] As explained in the Adopting Release, the Amendments are designed to improve the FSOC's ability to monitor systemic risk since Form PF's adoption, bolster the SEC's regulatory oversight of private fund advisers, and gather information for regulatory purposes, including enforcement, examinations, and rulemaking.

Generally, Rule 204(b)-1 requires investment advisers that have at least $150 million in private fund assets under management ("AUM") to file Form PF on a quarterly or annual basis; frequency of filings and the Sections required to be completed are determined by the size and categorization of the type of private funds they advise.[4]

Prior to the Amendments, Form PF was comprised of five Sections. All advisers are required to report in Section 1 more generalized information, such as the types of private funds advised (*i.e.*, hedge funds, private equity funds, liquidity funds, real estate funds, securitized asset funds, venture capital funds and "other funds"), fund size, use of borrowings and derivatives, strategy, and types of investors. Three types of "Large Private Fund Advisers" are required to complete certain additional sections of Form PF, with large hedge fund, liquidity fund, and private equity fund advisers subject to more comprehensive reporting on their dedicated Sections 2, 3, and 4, respectively.

Following the Amendments, Form PF will have seven Sections, creating two new separate Sections of Form PF, Section 5 and Section 6. The current Section 5, the request for temporary hardship exemption, will become a new Section 7.[5] A "current report" under the new Section 5 and a "private equity event report" under the new Section 6 will each be filed as a stand-alone document through the same system used to file the rest of Form PF, the Private Fund Reporting Depository ("PFRD").[6] The Amendments also add and alter questions to existing Form PF Section 4. As applicable, the quarterly and annual reporting timeline has been maintained for existing Sections 1 through 4, with the new Sections 5 and 6 requiring an accelerated timeline for some advisers.

As a result, the Amendments to Form PF will affect only the following categories of advisers:

- Large Hedge Fund Advisers (*i.e.*, hedge fund advisers with at least $1.5 billion in hedge fund AUM);
- Private Equity Fund Advisers (*i.e.*, investment advisers with at least $150 million in private equity fund AUM); and
- Large Private Equity Fund Advisers (*i.e.,* private equity fund advisers with at least $2 billion in private equity AUM).

With respect to the last category, and in a change from its January 2022 Form PF Proposing Release, the Commission has not adopted a lower $1.5 billion in private equity fund AUM reporting threshold for Large Private Equity Fund Advisers. The existing threshold of $2 billion in private equity fund AUM will remain.

Under current rules, Exempt Reporting Advisers will not be required to file Form PF as a result of the Amendments.[7]

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### *New Section 5—Current Event Reporting for Large Hedge Fund Advisers*

The Amendments to Form PF will require Large Hedge Fund Advisers to file a current report on Section 5 as soon as practicable but no later than 72 hours from the occurrence of one or more triggering "current reporting events"[8] by a qualifying hedge fund. A "qualifying hedge fund" is a hedge fund, individually or in combination with any feeder funds, parallel funds, and/or dependent managed account, having a net asset value of at least $500 million.[9]

The 72-hour period is a departure from the timeline set forth in the SEC's January 2022 Form PF Proposing Release which would have required a private fund adviser to file reports as to certain events within one business day of the occurrence of any of such events, which would be the close of the business day following the day the event occurred.

Current reporting events include the following:

- **Extraordinary Investment Losses**: Advisers are required to file a current report if, as of any business day, the 10-business day holding period return of a reporting fund is less than or equal to 20% of the reporting fund aggregate calculated value.

- **Significant Increases In Margin, Collateral or an Equivalent**: Advisers are required to file a current report in connection with a significant increase in the value of a reporting fund's requirements for margin, collateral or an equivalent of 20% or more within a rolling 10-business-day period.

- **Inability to Meet a Margin Call or Margin Default**: Advisers are required to file a current report in connection with a margin default or inability to meet a call for margin, collateral or an equivalent, taking into account any contractually agreed cure period.

- **Default of a Counterparty**: Advisers are required to file a current report in connection with a counterparty's margin, collateral or equivalent default or failure to make other payment.

- **Prime Broker Relationship Terminated or Materially Restricted**: Advisers are required to file a current report following the termination or material restriction of a reporting fund's relationship with a prime broker.

- **Operations Event**: Advisers are required to file a current report when the adviser or qualifying hedge fund experiences a "significant disruption or degradation" of the fund's "critical operations," whether as a result of an event at the fund, the adviser, or other service providers to the fund. For this purpose, "critical operations" means "operations necessary for (i) the investment, trading, valuation, reporting, and risk management of the fund; or (ii) the operation of the fund in accordance with federal securities laws and regulations."

- **Significant Withdrawals and Redemptions**: Advisers are required to file a current report if the reporting qualifying hedge fund receives cumulative requests for withdrawals or redemptions from the reporting fund equal to or more than 50% of the most recent net asset value (after netting against subscriptions and other contributions from investors received and contractually committed).

- **Inability to Satisfy Redemptions**: Advisers are required to file a current report if the reporting fund (i) cannot pay redemption requests or (ii) has suspended redemptions, and such suspension lasts for more than five consecutive business days.

In a departure from the January 2022 Form PF Proposing Release, the SEC did not adopt a requirement that an adviser report a significant decline in holdings of unencumbered cash as a current reporting event.

### *New Section 6—Private Equity Event Reporting for All Private Equity Fund Advisers*

The Amendments to Form PF will require all Private Equity Fund Advisers to file an event report on Section 6 within 60 days of each fiscal quarter end upon the occurrence of one or more "private equity reporting events,"[10] which include:

- **Adviser-Led Secondary Transactions**: Private Equity Fund Advisers are required to file a private equity report upon completing an "adviser-led secondary transaction." An "adviser-led secondary transaction" is defined as any transaction initiated by the adviser or any of its related persons that offers private fund investors the choice to (1) sell all or a portion of their interests in the private fund, or (2) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

- **General Partner Removal, Termination of the Investment Period, or Termination of a Fund**: Private Equity Fund Advisers are required to file a private equity report when a fund receives notification that fund investors have (i) removed the adviser or an affiliate as the general partner (or similar control person) of the fund; (ii) elected to terminate the fund's investment period, or (iii) elected to terminate the fund.

### *Revised Section 4—Reporting Requirements for Large Private Equity Fund Advisers*

The Amendments to Form PF include a number of changes to the current existing Section 4 which requires Large Private Equity Fund Advisers to identify information about their private equity funds.

New questions have been added to Section 4.[11] Question 66 now asks advisers to select from a list of common investment strategies and report the percent of deployed capital for each, even if the categories don't perfectly match the fund's specific strategies. Question 68 requires additional information on any fund-level borrowing, including details on each borrowing or cash financing available to the fund, the total dollar amount available, and the average amount borrowed during the reporting period. Question 82 now requires reporting on general partner and certain limited partner clawbacks.

Amendments have also been made to existing questions in Section 4.[12] Question 74 now requires more detailed information on reported events of default, specifying whether it's a payment default of the private equity fund, a controlled portfolio company, or a default related to a failure to uphold terms of the borrowing agreement. Question 75 now requires reporting on the institutions providing bridge financing to the adviser's controlled portfolio companies and the amount of financing provided. Lastly, Question 78 now requires reporting on the geographical breakdown of investments by private equity funds, listing all countries by ISO country code to which a reporting fund has exposure of 10% or more of its net asset value.

There are two effective compliance dates for different Sections of Form PF. The Amendments to Section 4 take effect June 11, 2024. The Amendments for current and private equity event reporting in Sections 5 and 6 take effect December 11, 2023.

On August 10, 2022, the SEC and the U.S. Commodity Futures Trading Commission jointly released an August Proposal relating to technical changes to Form PF, which is still under consideration by the Commission.

## SEC Brings Fraud Charges Against Trump-Related SPAC

On July 20, 2023, the SEC announced that it had settled fraud charges against Digital World Acquisition Corporation ("DWAC"), a special purpose acquisition company ("SPAC"), in connection with material misrepresentations made in offering documents for DWAC's initial public offering and a subsequent merger transaction.[13] DWAC agreed to pay an $18 million penalty and to the entry of a cease-and-desist order. In its order, the SEC found that DWAC had made false

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statements regarding its entry into discussions with potential acquisition targets and had failed to disclose a significant conflict of interest relating to DWAC's proposed business combination transaction with Trump Media & Technology Group Corp. ("TMTG").[14]

Like other SPACs, DWAC went public with no operations of its own; instead, the $287.5 million raised in its September 2021 IPO was intended to be used in connection with a business combination with an operating company. In February 2021, a representative of TMTG approached "Individual A," who controlled "SPAC A," about a possible transaction involving TMTG and SPAC A. SPAC A and TMTG entered into a letter of intent in connection with the transaction, but the letter of intent expired in April 2021. Individual A, however, remained interested in a transaction with TMTG, and developed a "Plan A" and a "Plan B" to pursue such a transaction. Plan A involved continued pursuit of a merger of TMTG with SPAC A, potentially by removing officers of SPAC A who opposed the transaction. Plan B was to find another SPAC to merge with TMTG. Later that month, Individual A learned of an opportunity to obtain control of TMTG by acquiring a majority stake in its sponsor. Individual A completed this transaction, and became CEO and Chairman of TMTG, in May 2021. Individual A continued discussions with TMTG about a potential merger during this period.

Later in May 2021, DWAC filed an S-1 with the SEC for its IPO. The S-1 included a statement by DWAC that "[w]e have not selected any specific business combination target and we have not, nor has anyone on our behalf, engaged in any substantive discussions, directly or indirectly, with any business combination target with respect to an initial business combination with us."[15]

In June 2021, TMTG, SPAC A, and Individual A entered into a new letter of intent regarding a merger between SPAC A and TMTG. This letter of intent included a break-up fee clause pursuant to which Individual A would personally pay a $1 million fee if SPAC A and TMTG did not enter into a definitive acquisition agreement by a specified date that was subsequently extended to October 2021. The letter of intent provided, however, that this fee would not be payable if Individual A proposed to TMTG a transaction with a different SPAC that TMTG elected to accept.

Shortly after signing the June letter of intent, Individual A began telling others of his desire to use DWAC as the vehicle to merge with TMTG. He spent a day in a July meeting with TMTG management, and communicated in August with a DWAC representative about the timing of a transaction announcement. Later that month, DWAC filed an amended S-1 that included additional statements to the effect that up until that point, it had not had any substantive discussions with any potential acquisition targets. The DWAC IPO was completed in September. Shortly afterwards, SPAC A and TMTG signed a termination agreement releasing Individual A from any obligation to pay the break-up fee. DWAC and TMTG entered into a merger agreement in October 2021.

In May 2022, DWAC filed an S-4 to register shares issuable pursuant to the merger with DWAC. The S-4 did not disclose the existence of the break-up fee provision or the conflict of interest it created with respect to Individual A. It also failed to disclose any of the many contacts between Individual A and TMTG prior to the completion of DWAC's IPO.

The SEC concluded that the statements in DWAC's S-1 regarding the purported absence of discussions with any potential transaction target were false, and that the discussion in its S-4 of the background of the transaction was misleading because it omitted material facts about Individual A's pre-IPO discussions with TMTG and the break-up fee.

Gurbir S. Grewal, Director of the SEC's Division of Enforcement, stated "DWAC failed to disclose its discussions with TMTG and failed to disclose a material conflict of interest of its CEO and Chairman. In the context of a SPAC—a 'blank-check' entity without business operations—these disclosure failures are

particularly problematic because investors focus on factors such as the SPAC's management team and potential merger targets when making financial decisions."[16]

## SEC Charges Operator of Collectibles Marketplace with Operating an Unregistered Securities Exchange

On July 12, 2023, the SEC announced that it had settled charges against RSE Markets Inc. ("RSE") for operating an unregistered securities exchange.[17] Tejal D. Shah, Associate Regional Director of the SEC's New York Regional Office, said "RSE operated and marketed its platform as an exchange but failed to comply with the SEC's registration provisions. When a firm operates an unregistered trading platform, as RSE did, it deprives investors of important protections under the securities laws, including requirements to file disclosures with the Commission and create and maintain certain books and records."[18]

According to the SEC's order, RSE maintained the "Rally Platform," consisting of a website, an app and related trading functionality. The platform was used by U.S. retail investors for the purchase and sale of equity interests issued by RSE affiliates in collectible assets like expensive cars, sports memorabilia and watches.[19] These equity interests were issued under Tier II of SEC Regulation A.

The Rally Platform was marketed to retail investors, who were required to create user-specific accounts to trade equity interests, and thousands of people did so. Secondary trading in the securities occurred during designated trading windows. The RSE website contained instructions for investors regarding how to submit purchase and sale orders, and explained how those orders were matched by RSE's algorithms. Once orders were matched, both sides of the trade were asked to confirm their desire to transact, after which RSE sent trade information to a broker-dealer for clearing. Virtually all matched orders were subsequently confirmed.

Section 5 of the Securities Exchange Act of 1934 (the "Exchange Act") makes it unlawful to operate a securities exchange that is not registered under that act. A rule under the Exchange Act states that an entity acts as an exchange if it brings together orders for securities of multiple buyers and sellers and uses established, non-discretionary methods under which such orders interact with each other.[20] According to the SEC, the Rally Platform met this definition by matching orders of market participants and providing an algorithm that determined the clearing price of trades. In addition, RSE publicly marketed the platform as a "stock exchange" and a "stock market."

Without admitting or denying the SEC's findings, RSE agreed to pay a $350,000 penalty and to cease and desist from committing or causing any violations and any future violations of Section 5 of the Exchange Act.

## SEC Proposes Amendments to the Broker-Dealer Customer Protection Rule

On July 12, the SEC proposed amendments (the "Rule Proposal") to Rule 15c3-3 under the Exchange Act (the "Customer Protection Rule") to require certain broker-dealers to change the frequency with which they compute the net cash they owe to customers and other broker-dealers (known as PAB account holders) from a weekly basis to a daily basis.[21] As part of the proposed rule, the SEC is also seeking comments on whether similar daily reserve computations should apply to broker-dealers and security-based swap dealers for their security-based swap customers.[22]

Among other things, the Customer Protection Rule requires broker-dealers that maintain custody of customer securities and cash ("carrying broker-dealers") to have a special reserve account for the exclusive benefit of customers (a "customer reserve bank account") and a special reserve bank account for broker-dealers (a "PAB reserve bank account") that are separate from each other and from the broker-dealers' other bank accounts.[23] At all times, carrying broker-dealers are required to maintain cash and/or qualified securities based on a computation of the net cash owed to the broker-dealer's customers in the customer reserve bank account and the PAB reserve bank account.[24] Generally, carrying broker-


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dealers are required to perform this computation and make any required deposits into the reserve bank account at least weekly.[25]

The proposed amendments to the Customer Protection Rule would require carrying broker-dealers with $250 million or more average total credits owed to customer and PAB account holders to perform those computations and make required deposits on a daily basis (as opposed to weekly), as of the close of the prior business day.[26] Such deposits would be required to be made within one hour after the opening of banking business on the following business day.[27] As part of the Rule Proposal, the Commission is proposing to define average total credits to mean, the "arithmetic mean of the sum of total credits in the customer reserve computation and PAB reserve computation reported in the twelve most recently filed month-end FOCUS Reports."[28]

As discussed in the Rule Proposal, cash owed to customers and PAB account holders can include cash proceeds from sales of securities, cash deposits from customers and PAB account holders, and dividends received on behalf of customers and PAB account holders. And, because carrying broker-dealers may owe large amounts of cash to customers and PAB account holders, they can incur large deposit requirements from time to time.[29] Noting the mismatch between the net amount owed and the amount on deposit due to the weekly computation and deposit requirement, the Rule Proposal includes that the objective of the proposal is to, "reduce the risk caused by this mismatch for carrying broker-dealers where the difference between the net amount owed and the amount on deposit potentially is substantial."[30] The Rule Proposal further notes that large mismatches can lead to large shortfalls in amounts available in customer and PAB reserve accounts, to make customers and PAB account holders whole if the carrying broker-dealer fails.[31]

## ENDNOTES:

[1]*See* https://www.sec.gov/news/press-release/2023-86.

[2]*See* Instruction 1.C. to Form PF.

[3]*See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Advisers Act Rel. No. 3308 (Oct. 2011) (the "Form PF Adopting Release").

[4]*See* Form PF Adopting Release.

[5]*See* Form PF; Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers; Requirements for Large Private Equity Fund Adviser Reporting, Advisers Act Rel. No. IA-6297 (May 2023) (the "Form PF Amendments Release").

[6]Form PF is filed on PFRD through the Investment Adviser Registration Depository system, which charges a $150 filing fee for the Initial Form PF and each Update filing. *See* https://www.iard.com/pfrd/default.

[7]*See* Form PF Amendments Release.

[8]*See* Form PF: Glossary of Terms, p. 3, in the Amendments Release.

[9]*See* Form PF: Glossary of Terms, p. 11, in the Amendments Release.

[10]*See* Form PF: Glossary of Terms, p. 10, in the Amendments Release.

[11]*See* Form PF Amendments Release, pp. 70-79.

[12]*See* Form PF Amendments Release, pp. 79-88.

[13]*See* https://www.sec.gov/news/press-release/2023-135.

[14]*See* https://www.sec.gov/files/litigation/admin/2023/33-11213.pdf.

[15]*See* https://www.sec.gov/files/litigation/admin/2023/33-11213.pdf.

[16]*See* https://www.sec.gov/news/press-release/2023-135.

[17]*See* https://www.sec.gov/news/press-release/2023-132.

[18]*See* https://www.sec.gov/news/press-release/2023-132.

[19]*See* https://www.sec.gov/files/litigation/admin/2023/34-97878.pdf.

[20]*See* 17 CFR § 240.3b-16.

[21]*See* https://www.sec.gov/news/press-release/2023-130.

[22]*See* https://www.sec.gov/files/rules/proposed/2023/34-97877.pdf.

[23] *See* 17 CFR § 240.15c3-3.

[24] *See* 17 CFR § 240.15c3-3. *See also*, https://www.sec.gov/files/rules/proposed/2023/34-97877.pdf.

[25] *See* 17 CFR § 240.15c3-3. *See also*, https://www.sec.gov/files/rules/proposed/2023/34-97877.pdf.

[26] *See* https://www.sec.gov/files/rules/proposed/2023/34-97877.pdf; *See also*: https://www.sec.gov/files/34-97877-fact-sheet.pdf.

[27] *See* https://www.sec.gov/files/rules/proposed/2023/34-97877.pdf.

[28] *See* https://www.sec.gov/files/rules/proposed/2023/34-97877.pdf.

[29] *See* https://www.sec.gov/files/rules/proposed/2023/34-97877.pdf.

[30] *See* https://www.sec.gov/files/rules/proposed/2023/34-97877.pdf.

[31] *See* https://www.sec.gov/files/rules/proposed/2023/34-97877.pdf.


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# FROM THE EDITOR

## A Ripple in Time

The Securities and Exchange Commission has been arguing for years that digital assets, particularly cryptocurrencies, should be considered securities and are thus subject to the same SEC regulations as stocks and bonds. In 2023, the Commission has been going hard after some of the world's largest crypto exchanges, including Coinbase and Binance—accusing them of marketing unregistered securities to the public.

Last month's *SEC v. Ripple* decision, however, has pushed back on the SEC's argument, to an extent. As per our lead article this month, written by Morrison & Foerster's Michael Birnbaum, Jeff Silberman, Haimavathi Marlier, and Michael Burshteyn, "the decision granted and denied in part both the SEC's and Ripple's cross-motions for summary judgment, leaving only the relatively narrow question of the individual defendants' alleged role in Ripple's violations unresolved."

"*Ripple* is not a clean victory for the SEC or the crypto-industry, and may very well be appealed by either or both sides," the authors write. "Indeed, much of Judge Torres' opinion leaves considerable room for interpretation, not only as to what tokens might be deemed to be securities subjecting certain transactions to registration requirements, but also regarding in what contexts such token transactions will constitute investment contracts. As such, market participants should be cautious in relying solely on the *Ripple* decision when contemplating future transactions. Nevertheless, *Ripple* is an important addition to caselaw. . .and warrants close attention."

Certainly, for many in the crypto industry, it's understandable that market players are treating *Ripple* as a well-needed victory in a long struggle with the SEC. Ripple's chief legal officer Stuart Alderoty called the ruling "a win for the broader crypto industry," telling the *New York Times* that "the decision puts appropriate checks and balances on the SEC's campaign of regulation by enforcement."

"On the heels of SEC victories in *Telegram, Kik,* and *LBRY*, the *Ripple* decision offers some reasons for optimism for crypto market participants that, under certain circumstances, transactions in crypto tokens will not be subject to federal registration requirements," the Morrison & Foerster attorneys write. They added that "observers should be cautious to avoid treating any pronouncements in *Ripple* as gospel, however, as the decision (which is still subject to appeal) was careful to emphasize the specific facts driving its conclusions, leaving ample room for different holdings where token issuers present different factual contexts."

Chris O'Leary

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