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SEC ACTION AGAINST CHEETAH MOBILE EXECS SHOWS RULE 10B5-1 PLANS ARE NOT A GET OUT OF JAIL FREE CARD

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On September 21, 2022, the Securities and Exchange Commission announced a settled enforcement action against two executives of China-based mobile internet company Cheetah Mobile, Inc.[1] The SEC alleged that Sheng Fu, Cheetah Mobile's CEO, had caused the company's misleading statements and failures to disclose a material negative revenue trend and that, after becoming aware of the trend, he and Ming Xu, Cheetah Mobile's former President and Chief Technology Officer, sold securities pursuant to an improperly established Rule 10b5-1 trading plan and avoided a few hundred thousand dollars in losses. This is a rare SEC action stemming from improper use of a Rule 10b5-1 trading plan, and it may signal a shift in future SEC enforcement and increased scrutiny of trading pursuant to Rule 10b5-1 trading plans.

Key Takeaways

- The SEC is closely scrutinizing Rule 10b5-1 plans, and such plans should not be seen as get out of jail free cards to avoid insider trading liability;
- Insiders cannot be in possession of material nonpublic information ("MNPI") when they put a plan in place; otherwise, the plan cannot serve as an affirmative defense to an allegation of insider trading;
- The SEC's view of information that constitutes MNPI may be expanding and what is considered material will be assessed with hindsight; and
- The best practice for Rule 10b5-1 plans is to have a cooling-off period between putting the plan in place and when the planned trades begin.

Facts of the Case

Cheetah Mobile earned up to one-third of its revenues from an advertising partner that placed third-party advertisements on Cheetah Mobile's mobile platforms. In the summer of 2015, the advertising partner informed Cheetah Mobile that it would be changing its algorithm that determined the fees for ad place-

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ment and that, unless Cheetah Mobile improved the quality of its ad placements, the algorithm change could cut the partner's payments to Cheetah Mobile in half. Cheetah Mobile was unable to accommodate the new algorithm but, according to the SEC, when its revenue began to decline, Cheetah Mobile's CEO offered a materially misleading explanation to investors and analysts during an earnings call when he referred to the decline in revenue as being due to "seasonality" and caused by "some declines in one of our largest third party advertising platform partners, where we see significant sequential moderations in sales there." The SEC alleged that the CEO's statements about revenue trends and expectations were materially misleading because the CEO did not disclose that the algorithm change had created **a negative trend in revenue** and the trend was persistent and not seasonal. The company also failed to disclose this "known trend" in its annual report filed with the SEC that the CEO signed.

The SEC alleged that while they were aware of the material negative trend in revenues from the advertising partner, Cheetah's CEO and then-President entered into Rule 10b5-1 trading plans to sell some of their Cheetah Mobile securities. The SEC claimed that because they sold before Cheetah Mobile disclosed lower than expected second-quarter guidance, the executives avoided losses of approximately $203,290 and $100,127, respectively.

A New Enforcement Trend?

This case is unusual for at least a couple reasons. First, the SEC seldom charges individuals who have traded pursuant to Rule 10b5-1 trading plans. Rule 10b5-1 trading plans can be particularly useful for individuals presumed to have nonpublic information, such as directors, officers, or executives of a company. By certifying that they do not possess material nonpublic information at the time they enacted the plan, they can establish an affirmative defense to a charge of insider trading, even if they become aware of MNPI after the plan is in place but before the trade is completed. But the existence of a Rule 10b5-1 trading plan, standing alone, is not enough to protect against liability: the plan must be entered into in good faith. While insider trading actions involving Rule 10b5-1 plans are not common, the SEC has shown that trades made while executives had knowledge of nonpublic information will be scrutinized, even if a Rule 10b5-1 plan exists.

Second, the SEC's definition of what information constitutes MNPI may be expanding. While many

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insider trading cases relate to earnings announcements or potential mergers and acquisitions, in this case the MNPI that the executives were charged with trading on was an undisclosed negative revenue trend. Interestingly, when the executives entered into the Rule 10b5-1 trading plans, Cheetah Mobile had already disclosed that it expected a decline in overall revenues in Q1 2016 compared to the immediately preceding quarter. But the company had not disclosed that the change in its advertising partner's algorithm had created what the SEC alleged was a negative trend in revenue.

Best Practices

On December 15, 2021, the SEC proposed amendments to the rules for Rule 10b5-1 trading plans.[2] While these rules have not yet been enacted, the Cheetah Mobile case signals an increasing appetite for heightened scrutiny of Rule 10b5-1 plans and subsequent trades. For years, critics have noted[3] that executives and insiders who trade pursuant to Rule 10b5-1 plans are more successful than others who do not use these plans and that the timing of trading and establishment of the plans seem to "game the system." The SEC's proposed rules—along with the Cheetah Mobile enforcement action—may also identify best practices for those who wish to trade pursuant to Rule 10b5-1 plans without exposing themselves or their companies to risk.

No MNPI When Establishing a Rule 10b5-1 Plan: Individuals who wish to trade should make sure that they are not in possession of material nonpublic information when they establish the Rule 10b5-1 plan. Companies and individuals wishing to trade should also think carefully about what might be considered material to investors; for example, an undisclosed negative trend in revenue could be material.

Institute a Cooling-off Period: Insiders should also consider a "cooling-off" period between enacting the plan and when trades begin under the plan. The SEC has proposed a period of at least 120 days; although no such restriction is currently in place, a delay between adoption of the plan and the start of trading can help support an argument that the plan was established in good faith. Notably, as part of the settlement, Cheetah Mobile's CEO agreed to a 120-day cooling-off period for any new Rule 10b5-1 plans he establishes for the next five years.

Ensure Robust Internal Controls: Companies and their counsel should also ensure that they have robust internal controls. They should look closely at their insider trading policy, enforcement of trading windows for enactment of Rule 10b5-1 plans, and review of modifications to Rule 10b5-1 plans. Because the SEC has proposed heightened disclosure requirements for Rule 10b5-1 planned trades, companies may also want to consider disclosure of executive plans.

By planning carefully, enacting strong internal controls, and thinking critically about what might be considered MNPI, companies, insiders, and their counsel can reduce risk and stay ahead of a shifting compliance landscape.

For more about Rule 10b5-1 plans and best practices, *see* https://www.mofo.com/resources/insights/200228-common-questions-rule-10b5, or listen to the MoFo Perspectives podcast "Above Board: Rule 10b5-1 Plans" (https://www.mofo.com/resources/podcasts/210316-above-board-plans). For more information about enforcement trends and proposed changes, please *see* "Rule 10b5-1 Plans at 20" (https://www.mofo.com/resources/insights/200226-enforcement-trends-best-practices).

ENDNOTES:

[1] https://www.sec.gov/news/press-release/2022-169.

[2] https://www.sec.gov/news/press-release/2021-256.

[3] https://www.wsj.com/articles/executive-stock-sales-questions-insider-trading-11656514551.

A DAO IS NO DEFENSE: CFTC SAYS DECENTRALIZATION DOES NOT IMMUNIZE DEFI FROM REGULATION

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The Situation: Under the existing legal regimes, decentralized autonomous organizations ("DAO" or "DAOs") have been viewed as a way to hedge against regulatory action by way of a decentralized structure. The Commodity Futures Trading Commission's ("CFTC") recent and first attempt to impose liability on a DAO and its members disrupts that assumption and helps provide insight into the future of decentralized finance ("DeFi") in the United States.

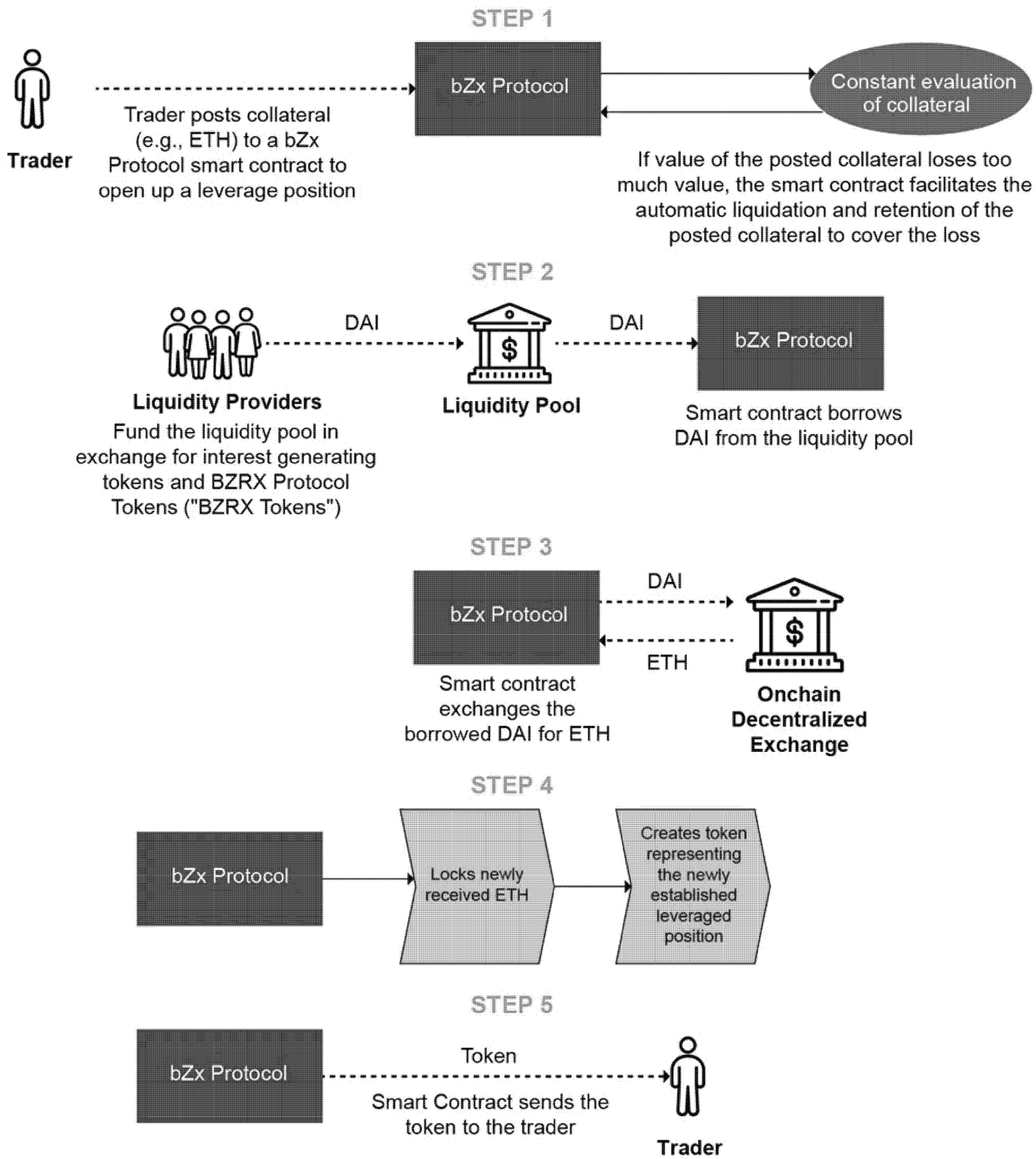
The Result: The CFTC's recent Order[1] found bZeroX, LLC and its two founders violated the Commodity Exchange Act ("CEA") by unlawfully engaging in activities that could lawfully be performed only by a registered futures commission merchant ("FCM") or designated contract market ("DCM"), and contended that individual DAO members that voted on governance measures are jointly and severally liable for debts of the DAO as an unincorporated association.

Looking Ahead: The CFTC's complaint against Ooki DAO (the successor to bZeroX's DAO that operated the same software protocol as bZeroX) charged the same violations that the CFTC found in the Order. Even if the federal court does not adopt the CFTC's "unincorporated association" theory of liability for DAO voters, its very prospect seems likely to chill DeFi participation in the United States in the near future.

Overview

On September 22, 2022, the CFTC filed an Order announcing it had reached a settlement with bZeroX, LLC and its two founders, Kyle Kistner and Tom Bean (collectively, "Respondents"). The settlement relied in part on imposing controlling person liability on the founders, under Section 13(b) of the CEA, for bZeroX's violations of CEA Sections 4(a) and 4(d)(1). The Order found that the Respondents violated the CEA by operating an Ethereum-based DeFi platform ("bZx Protocol") that accepted orders and facilitated tokenized leveraged retail trading of virtual currencies such as ETH, DAI, and others.

According to the Order, the bZx Protocol permitted users to contribute margin to open leveraged positions, the ultimate value of which was determined by the price difference between two digital assets from the time the position was established to the time it was closed. In doing so, the CFTC found, the Respondents "unlawfully engaged in activities that could only lawfully be performed by a designated contract market ('DCM') and other activities that could only lawfully be performed by a registered futures commission merchant ('FCM')." The CFTC also found, by Respondents failing to conduct know-your-customer diligence on customers as part of a customer identification program, as required of both registered and unregistered FCMs, that the Respondents violated CFTC Regulation 42.2. On the next page is an illustration of how the bZx Protocol operated.



Concurrently with the Order,[2] the CFTC filed a complaint against Ooki DAO, the successor to the bZx DAO—a DAO comprising bZx Protocol token holders that Respondents had transferred control to following a series of hacks in 2020 and early 2021. The Ooki DAO complaint charges the same violations in which the CFTC found in the Order that the Respondents had engaged. The CFTC characterized Ooki

DAO in the Order as "an unincorporated association comprised of holders of Ooki DAO Tokens who vote those tokens to govern (*e.g.*, to modify, operate, market, and take other actions with respect to) the [Ooki] Protocol." In the Order, the CFTC stated that "[i]ndividual members of an unincorporated association organized for profit are personally liable for the debts of the association under principles of partnership law."

As discussed in Commissioner Mersinger's dissent ("Mersinger's Dissent"), neither the CEA nor the CFTC have ever defined a DAO. More importantly, although the CFTC has to date settled one action against what it characterized as a DeFi trading platform (Blockratize, Inc. d/b/a Polymarkets.com),[3] the Ooki DAO complaint is the first time it has attempted to impose liability on a DAO or its members. This was not entirely unexpected. For example, in footnote 63 in the CFTC's Digital Asset Actual Delivery Interpretive Guidance,[4] the CFTC noted that "in the context of a 'decentralized' network or protocol, the Commission *would* apply this interpretation to any tokens on the protocol that are meant to serve as virtual currency as described herein" (emphasis added).

The CFTC added that "[i]n such instances, the Commission could, depending on the facts and circumstances, view 'offerors' as any persons presenting, soliciting, or otherwise facilitating 'retail commodity transactions,' including by way of a participation interest in a foundation, consensus, or other collective that controls operational decisions on the protocol, or any other persons with an ability to assert control over the protocol that offers 'retail commodity transactions,' as set forth in CEA section 2(c)(2)(D)."

Former CFTC Commissioner Berkovitz also stated in a 2021 speech that "[n]ot only do I think that unlicensed DeFi markets for derivative instruments are a bad idea, I also do not see how they are legal under the CEA."[5] A few years prior to that, a CFTC spokesperson stated in response to questions about Augur—a DeFi prediction market offering, among other things, assassination contracts—that "[w]hile I won't comment on the business model of any specific company, I can say generally that offering or facilitating a product or activity by way of releasing code onto a blockchain does not absolve any entity or individual from complying with pertinent laws or CFTC regulations[.]"[6] The CFTC's unincorporated association theory of liability is not unique: The SEC's 2017 DAO Report pointed out that Section 3(a)(1) of the Securities Exchange Act of 1934 defines an "exchange" as "any . . . association, or group of persons, whether incorporated or unincorporated . . .."[7]

However, as noted in Mersinger's Dissent, "[d]efining the Ooki DAO unincorporated association as those who have voted their tokens inherently creates inequitable distinctions between token holders." For instance, a single vote on a generic governance proposal having nothing to do with the CEA or CFTC rules could unknowingly subject token holder A to membership in the unincorporated association, as defined by the CFTC, and assumption of personal liability, while token holder B escapes membership/liability by virtue of incidentally neglecting to vote. Even if token holder A had voted directly against the alleged unlawful actions, it could still face joint and several liability for the full legal claim against the DAO.

Moreover, as noted in Mersinger's Dissent, the CEA "sets out three legal theories that the Commission can rely upon to support charging a person for violations of the CEA or CFTC rules committed by another: (i) principal-agent liability; (ii) aiding-and-abetting liability; and (iii) control person liability." The CFTC has pursued the aiding-and-abetting theory in somewhat similar circumstances. In January 2018, the CFTC charged Jitesh Thakkar and Edge Financial Technologies, Inc.—a company Mr. Thakkar founded and for which he served as president—with aiding and abetting Navinder Sarao in engaging in a manipulative and deceptive scheme by designing software used by Mr. Sarao to spoof mini S&P futures contracts.[8]

Mr. Thakkar was also named in a criminal complaint brought by the Department of Justice ("DOJ") related to the same conduct on charges of conspiracy to commit spoofing as well as aiding and abetting spoofing. The CFTC agreed to stay its case during the pendency of the criminal matter. After the DOJ's charges were dismissed with prejudice in April 2019,[9] the CFTC resumed its civil action against Mr. Thakkar in September 2019. One year later, the CFTC ultimately entered into a consent order for permanent injunction with Mr. Thakkar's company, Edge Financial Technologies, Inc.[10] The order included findings tracking the allegations in the CFTC's complaint, a permanent injunction against aiding-and-abetting violations of CEA Sections 4c(a)(5)(C) (spoofing) and 6(c)(1) (manipulation) and CFTC Regulation 180.1(a)(1) and (3) (relating to the use of a manipulative and deceptive device, scheme, or artifice to defraud), and an order of disgorgement and civil monetary penalty totaling $72,600.

While Commissioner Mersinger may have wished to hold only the founders liable for DAO-related activity, it would seem that the Commission is not so inclined and may wish to send a message to those who would trade on unlawful venues, even though the Commission usually seeks to protect such persons against misconduct arising from trading on such venues. In the case of DAOs, the Commission may take the view that such persons operate and control the venues, in some ways.

Even if this "unincorporated association" theory of DAO liability is not ultimately endorsed by a federal court, this ruling will likely result in protocol founders increasingly choosing to maintain anonymity and/or operate offshore. This could result in decreased availability of DeFi derivatives trading to U.S. persons and, if DeFi derivatives trading remains available to U.S. persons from offshore, greater extraterritorial enforcement efforts by the CFTC.

More broadly, this action is a warning that some regulators view unregulated DeFi trading activity as incompatible with existing legal structures, notwithstanding the argument that DAO token holders are engaged in active management of the protocol and so are not dependent on the efforts of others under *SEC v. Howey Co.* Footnote 10 of the bZeroX Order sounds loud and clear on this point, warning that "[i]t was (and remains) Respondents' responsibility to avoid unlawfully engaging in activities that could only be performed by registered entities and, should they ever wish to register, *to structure their business in a manner that is consistent with Commission registration requirements*" (emphasis added).

Incidentally, the message in that footnote is the answer to questions raised by some as to how crypto businesses are to operate when their very structures seem incompatible with existing regulatory schemes.[11] More recently, SEC Chairman Gensler expressed a similar sentiment, stating that "[t]he commingling of the various functions within crypto intermediaries creates inherent conflicts of interest and risks for investors. Thus, I've asked staff to work with intermediaries to ensure they register each of their functions—exchange, broker-dealer, custodial functions, and the like—*which could result in disaggregating their functions into separate legal entities to mitigate conflicts of interest and enhance investor protection*" (emphasis added).[12]

DAOs possess many novel qualities not present in traditional corporate structures—transitory ownership tied to a tradeable token, user ownership and governance, and operations conducted by, in some cases, an autonomous smart contract code. While encompassing only active voters in the instant case, the CFTC's language in its complaint against Ooki DAO seems to suggest that a smart contract protocol running programs deemed to violate regulations could continuously generate liability for DAO members simply by way of the members having "permitted" transactions executed by such programs. The greater the autonomy and automation of the smart contract underlying the protocol, the less sense attaching joint and several liability to DAO members arguably makes. Automating protocol functions to reduce the necessity of DAO member input is another foreseeable result of the CFTC's position.

While the potential for DAOs to avoid classification of their tokens as securities has reinforced the use of a fully decentralized structure lacking legal form, the countervailing risk of a general partnership—and especially voting member liability as an "unincorporated association"—will likely lead to increased use of traditional legal entities in DAO formation and governance for the DAO and individual participants alike.[13] For all of the innovation the unique traits of a DAO allows, it is becoming increasingly clear that existing regulations will demand the rails of legal personhood to achieve compliance.

Whether a "test case" ramping up to something larger or simply a reminder to founders—or those who otherwise seek to legally or practically distance themselves from the DAOs that they create (*e.g.*, by the developers "giv[i]n[g] up ownership over the 'escape hatch' function, which would allow a designated party to shut the system down[]"[14])—that DAOs cannot be used as a tool to evade regulatory action, the outcome of the CFTC's lawsuit against Ooki DAO is one to closely watch as a harbinger for DeFi as a whole. User ownership and voted token participation in DAOs—while not the regulatory shield some might wish it to be—is an idea unlikely to go away anytime soon.

Three Key Takeaways

1. The CFTC's Ooki DAO complaint serves as warning to the DeFi market to conform to the existing legal structure and could place a premium on founder anonymity or reduce DeFi protocol access for U.S. citizens. This outcome could result in further extraterritorial enforcement efforts by the CFTC as protocols shift operations overseas to avoid unlawfully engaging in activities allowable only by registered entities.

2. The CFTC finding active voters personally liable under principles of partnership law will likely cause DAOs to increase their levels of autonomy and automation, which would reduce the necessity of DAO member input and make the argument attaching joint and several liability to DAO members less viable.

3. The risk of DAOs' classification as general partnerships and individual voting members' potential personal liability under an unincorporated association theory will likely lead to the increased use of traditional legal entities in DAO formation and governance.

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] https://www.cftc.gov/media/7676/enfbzeroxorder092222/download.

[2] https://www.cftc.gov/media/7681/enfookicomplaint092222/download.

[3] https://www.cftc.gov/media/6891/enfblockratizeorder010322/download.

[4] https://www.cftc.gov/sites/default/files/2020/06/2020-11827a.pdf.

[5] https://www.cftc.gov/PressRoom/SpeechesTestimony/opaberkovitz7.

[6] https://www.bloomberg.com/news/articles/2018-07-26/as-crypto-meets-prediction-markets-u-s-regulators-take-notice.

[7] https://www.sec.gov/litigation/investreport/34-81207.pdf.

[8] https://www.cftc.gov/PressRoom/PressReleases/7689-18.

[9] https://business.cch.com/srd/USvThakkarMTDgranted042319.pdf.

[10] https://www.cftc.gov/media/4661/enfedgefinancialconsentorder091420/download.

[11] https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement092821b.

[12] https://www.sec.gov/news/speech/gensler-sec-speaks-090822.

[13] https://ssrn.com/abstract=4123737.

[14] https://www.coindesk.com/markets/2018/07/25/the-first-augur-assassination-markets-have-arrived/.

EVALUATING FINANCING PROPOSALS AND LENDER PROTECTIONS TO ACCOMMODATE NEW DEBT

By Thomas V. de la Bastide III, David Tarr, Monica K. Thurmond and Joseph Friedman

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Amid a shift to private credit providers who are ready, willing and able to fill the gap left by traditional lenders, understanding the universe of incremental debt and ratio debt rules is important to limit surprises for sponsors, companies, and lenders. We highlight these provisions, including key protections and other considerations that each side should take into account as incremental financing opportunities and new debt commitments are pursued in the current credit environment.

Overview

As the leveraged finance landscape continues to face headwinds from rising interest rates, inflation and other macroeconomic trends, private equity funds and their portfolio company borrowers are seeking additional ways to obtain liquidity for acquisitions and working capital while complying with existing debt documents. At the same time, debt investors are looking for new ways to deploy funds in search of desired yield while safeguarding their investments. In light of this backdrop and the dislocation of the syndicated debt market, a window of opportunity has opened for private credit funds to amplify their market position by providing funds into existing syndicated credit structures.

The shift to private credit providers who are ready, willing and able to fill the gap left by traditional lenders has raised new and interesting credit compliance questions. Adjustments to existing debt agreements are becoming more typical (and perceived as necessary) to obtain financing. The permitted scope of these adjustments, and whose consent is required to make them effective, often centers on syndicated credit agreements' incremental provisions and ratio debt exceptions, which allow companies to incur significant amounts of additional secured indebtedness subject to certain conditions.

This article highlights certain considerations that borrowers and creditors should take into account in analyzing this type of debt incurrence. It explains the strong value these provisions afford to borrowers and the inherent risks to existing creditors that may not be focused on their existence until subsequent debt is incurred. It also will be useful for incoming lenders looking for elegant solutions to lend on more favorable terms than may be available under the accordion by relying on the incremental-in-lieu or other ratio debt baskets discussed below.

Structuring Considerations

At a high level, two overarching structuring considerations with incremental debt and ratio debt are: (a) whether the debt will be slotted in as incremental loans under an existing credit agreement and, if so, will it be an *identical* tranche or have *different* economic and/or non-economic terms, and (b) whether the debt will be incurred under a *separate* debt agreement and, if so, how will the terms vary from the original loan.

There are times when a borrower and lender will prefer to pursue incremental financing and ratio debt with identical terms to existing debt. Speed and efficiency are often paramount, and the accordion mechanics found in many credit agreements allow for new financing to be injected in a structure with a pari passu lien without documenting a new loan agreement, collateral agreements, or intercreditor arrangement. A new lender can therefore benefit in the payment waterfall as if it had signed up to the deal from day one and save time and money by foregoing complex negotiations related to new debt agreements. Another benefit of increasing an existing tranche is that the new debt may be fungible from a trading and tax standpoint (depending on certain attributes and fees, especially OID), increasing the liquidity on the secondary market and ease of syndication.

On the other hand, especially given current volatility, new financings are seeing a scaling back of the pre-2022 sponsor terms in favor of pro-creditor changes. Relative to existing debt, creditors may now require higher pricing, larger fees, greater amortization, additional guarantees and collateral, earlier maturity, enhanced voting protection and one or more financial maintenance covenants. Depending on which existing debt basket is relied upon, these credit enhancements may be obtainable without existing lender or agent consent, all while granting the new lender a pari passu lien on the collateral. These enhancements may be structured to exclusively benefit the new lender or may be required to benefit all lenders, depending on the applicable provisions in the existing credit agreement. Advance notice to the existing lenders may not even be required. A company and its equity holders may be willing to accept more restrictive terms if it will induce a lender to provide much-needed capital in support of an add-on acquisition, enhanced liquidity or refinancing of debt with a looming maturity.

Types of Incremental Financings and Ratio Debt

Will the new debt be identical to, or different from, existing debt? How widely may the terms vary with (or without) existing lender consent? Which protections for existing lenders are most effective against different lending structures? These questions require careful analysis of the incremental and ratio prongs.

Syndicated credit agreements negotiated in the most recent borrower-friendly credit cycle frequently contain four related debt baskets: (i) the accordion, (ii) the incremental-in-lieu basket (usage of which reduces accordion capacity on a dollar-for-dollar basis), (iii) the ratio debt basket, and (iv) the acquisition debt basket.

Rules governing these baskets are often in unexpected places, separate and apart from the debt baskets themselves. It is incumbent on readers to familiarize themselves with the relevant definitions and component defined terms, the rules of construction, the lien covenant if secured debt is being incurred, other sections within the document related to new facilities and the company's other debt agreements, especially any intercreditor agreement, to ensure the additional facility is permitted on the desired terms.

A. Accordion (aka Incremental Financing)

The accordion is probably the most well-known provision for raising additional indebtedness under an existing credit agreement. The accordion or so-called incremental provisions provides the borrower flexibility to increase the aggregate amount of debt available under a facility or to establish a new facility, so long as a lender is willing and able to provide such financing. It is not a commitment to provide debt, but allows funded debt to be incurred efficiently. The full contours of the accordion are outside the scope of this memo, but the provisions will often include (a) a free and clear basket that allows pari passu secured debt to be incurred without a leverage condition (and may allow for capacity under the so-called "General Debt" basket to be reallocated under the accordion), (b) a ratio prong permitting uncapped debt subject to satisfying certain financial ratios on a pro forma basis for the new incurrence, and (c) a prepayment prong that gives a dollar-for-dollar credit for certain voluntary prepayments. The provisions will be subject to a litany of criteria designed to balance the need for a borrower to have freedom to contract with incremental lenders while protecting existing lenders through restrictions related to quantum, maturity, weighted average life to maturity, pricing, guarantees and collateral, mandatory prepayments, and certain other terms.

B. Incremental-in-Lieu Debt (aka Incremental Equivalent Debt)

Although relied on less frequently than the accordion, the incremental-in-lieu basket can offer a powerful alternative. At a high level, it allows a company to use available incremental capacity in lieu of the accordion to incur equivalent amounts of debt pursuant to a new debt agreement (aka a "sidecar facility"); the rub is that it may be subject to less stringent rules than the accordion. The new debt can often take a variety of forms—loans, notes, debentures or other debt securities—whereas the accordion is limited to loans. The diversity it offers in terms of the *form* of new debt may have important implications for pricing as detailed below.

Another implication of a sidecar facility is that a new lender will likely have greater control and influence on voting (as a substantial holder under a separate debt document, as opposed to being a minority holder under an existing credit agreement). Loan agreements typically require at least 50.1% consent thresholds to give effect to an amendment or waiver, except for certain sacred rights. A new lender will have more confidence that the terms of its deal will not be altered if it can remain at the helm and not be diluted by the loans of other holders.

C. Ratio Debt

Similarly, another carve-out under the negative covenants—the ratio debt basket—may exclude lender protections found in the accordion. Syndicated credit agreements will generally allow the ratio debt basket to be used for pari first lien debt subject to the same ratio levels as those in the incremental provisions. However, the ratio debt basket may be subject to fewer rules, particularly related to maturity. Other differences may lurk upon deeper inspection.

D. Acquisition Debt

The acquisition debt basket is similar to the ratio debt basket, but the use of proceeds is limited to debt incurred to finance a permitted acquisition or investment. Few, if any, intended differences may exist between the acquisition and the ratio debt basket, but it is not uncommon for contrasts to emerge compared to the accordion.

Key Protections for Lenders under Incremental and Ratio Debt Provisions

The guardrails that existing lenders look to install with respect to incremental and ratio debt may result in strong but inconsistent protections among the baskets described above. The nuances will be critical to a borrower when it is in need of capital. Pre-wired mechanics may authorize the collateral agent (or require the collateral agent) to enter into a pari passu intercreditor agreement or another form of acceptable intercreditor agreement that elevates new debt to a senior or equal position in the capital structure, further making the nuances among the baskets essential to evaluate.

1. MFN on Pricing

The key economic protection for existing lenders is the "most favored nation" or pricing MFN provision that provides that additional debt incurred within some time period (often between six and 24 months, though sometimes with no sunset) cannot have an "effective yield" in excess of the "effective yield" of the existing debt by a negotiated amount, often 50 basis points (or 75-100 basis points in certain sponsor-favorable deals). The pricing MFN could include a number of exceptions that render it inapplicable to certain categories of debt: for example, debt to finance a permitted acquisition, debt with a fixed rate (*e.g.*, bonds), debt that is not widely syndicated, debt denominated in currencies other than U.S. dollars, debt with a maturity longer than one or two years after the latest maturity of the existing debt, debt secured on a junior lien basis and/or debt incurred under the accordion's free-and-clear basket. Or there may be no exceptions at all, meaning existing creditors may generally expect bulletproof pricing MFN protection.

A borrower may be able to avoid triggering the pricing MFN provision based on how it structures a transaction. If the MFN provision includes an exception for incremental debt that is not widely placed, obtaining debt from a direct lender would generally be treated as meeting that exception. The source of capital can therefore be decisive to determining the applicability of the MFN. Similarly, many credit agreements do not include pricing protection with respect to incremental in-lieu debt (and ratio debt baskets) or may exclude it in the case of in-lieu debt in the form of notes or high yield bonds or any type of junior lien or unsecured debt. Let's assume a borrower raising $300 million has incremental capacity to do so, subject to a 50 bps MFN under its accordion, and will need to issue the debt at a premium to the original loans. To avoid ratcheting up the pricing of the existing loans, a company could potentially seek first lien debt in an equivalent amount, without triggering the MFN, pursuant to the in-lieu basket by memorializing the terms under a separate loan agreement or a note purchase agreement or Rule 144A offering. In this way, the incremental-in-lieu debt (or ratio debt) may offer a vehicle for financing a transaction that would be prohibitively expensive under the accordion.

2. MFN on Terms

Depending on the precedent and prior negotiations, existing lenders may benefit from a seldom discussed but powerful "terms MFN" provision. A terms MFN provision restricts the extent to which *overall* terms of a new financing can deviate from existing debt unless the existing debt similarly benefits, subject to pre-agreed carve-outs. Carve-outs will often include several fundamental terms, such as pricing, rate floors, fees, amortization, collateral, guarantees, and prepayment provisions. The exact carve-outs and the standard for determining compliance have important ramifications. Is it the borrower in good faith who determines whether the provision is satisfied or perhaps the borrower and the required lenders?

Subtle differences in phrasing have far-reaching impact—whether written as the new financing cannot be more favorable, *taken as a whole*, to the existing lenders, cannot be *materially* more favorable or must be *substantially consistent* with the existing terms can be determinative of whether non-conforming adjustments are acceptable (including as it relates to borrower's counsel's ability to issue a "no conflicts" opinion). Some credit agreements allow for any adjustments under this provision if deemed to reflect the "current market" at the time of issuance (often as determined in good faith by the borrower). Under this construct, a borrower has significant flexibility in structuring its new debt while limiting the impact on existing debt based on the terms' MFN provision.

3. Maturity and Weighted Average Life to Maturity

A common perception among creditors is that new pari debt cannot mature prior to the existing syndicated debt or have a shorter weighted average life to maturity. This is often the case with debt incurred under the accordion, subject to any inside maturity basket. In addition, the incremental in-lieu of basket and other ratio debts basket may not specify any maturity limitations. Therefore, in a difficult credit environment in which a lender seeks a short-term facility, the ratio debt basket may facilitate a transaction that would be rendered implausible based on other debt baskets or the accordion.

4. Guarantees and Collateral

Similarly, existing creditors may expect guarantees and collateral to remain as robust as any credit support being assigned to a new lender. That is often the case with the accordion that requires incremental debt to be secured by a lien on the collateral ranking pari passu or junior to the lien securing the existing obligations (or such debt may be unsecured). That protection may not carry over to the ratio or acquisition debt baskets. Further, the incremental in-lieu basket may have rules about guarantees and collateral, but may include room for asymmetric credit support, such as allowing holding companies or sister silos to pledge assets in favor of a new lender that would not be permitted under the accordion.

5. Non-Guarantor Sub-limits

One of the negotiated points that may surface with acquisition debt (and other incremental and ratio debt prongs) is the extent to which *non-guarantor subsidiaries* may incur incremental financing, given existing lender concern over structural subordination to such utilization. As a compromise to lenders, non-guarantor sub-limits may be inserted that cap the amount of debt available to non-guarantors. In more lender-favorable constructs, "shared" sub-limits are inserted, which require aggregating the debt accessible to non-guarantors among different baskets. Consistent with one of the overarching themes of this memo, these restrictions on non-guarantor incurrence may apply to certain ratio baskets but not all.

6. Mandatory Prepayments

It is common in syndicated deals for existing holders to be assured that new debt will not have greater than pro rata rights with respect to mandatory prepayments. The new creditors may share pro rata or less than pro rata, but not greater than pro rata. While the accordion and incremental-in-lieu baskets would be expected to contain these restrictions, the ratio and acquisition debt basket may not expressly feature them, although protections on this point may exist outside the negative covenants (such as in the mandatory prepayment section or pre-agreed form intercreditor agreement).

7. Financial Maintenance Covenants

For investors focused on financial covenants, provisions in credit agreements may prevent new more restrictive financial covenants unless all lenders are beneficiaries. This protection may be caveated, however. The credit document may provide that if a financial covenant is only added for the benefit of new revolving lenders, as is often the case, then such new financial covenant will benefit existing *revolving* lenders. Term lenders may wind up as indirect beneficiaries in the event of a default if the revolving lenders accelerate the obligations, but otherwise would not have a seat at the negotiating table in the event of a breach of the financial covenant.

Below is a summary of key lender protections in the context of incremental and ratio debt:

Type of Protection	Explanation
1. MFN on Pricing	The effective yield of certain new debt may not exceed a negotiated amount (perhaps 50 bps or more) relative to the existing loans, unless the pricing on the existing debt is increased to retain the negotiated cushion. The protection is often subject to carve-outs and may be subject to a sunset provision.
2. MFN on Terms	Terms and conditions of the new debt cannot be materially more favorable to the new lenders than (or more favorable, taken as a whole, or must be substantially consistent with) those of the existing loans, subject to certain carve-outs. A terms MFN may be inapplicable (a) to periods after the existing debt's maturity, (b) if the existing lenders receive the benefit of such favorable terms and conditions, (c) if the terms are reasonably satisfactory to the agent and/or (d) if the terms and conditions reflect then current market terms and conditions at the time of the incurrence.
3. Maturity Limitations	New debt cannot have an earlier maturity, except perhaps customary bridge loans and loans pursuant to an inside maturity basket.
4. Weighted Average Life to Maturity	New debt cannot have a shorter weighted average life to maturity, subject to any inside maturity basket. Otherwise, amortization may differ, or may not exceed some annual percentage.
5. Collateral and Guarantees	No subsidiary of a borrower can be a guarantor of the new debt if it is not a guarantor of the existing debt, and no asset can be encumbered as collateral in support of the new debt if not collateral for the existing debt. If secured, an intercreditor agreement is typically required.
6. Non-Guarantor Sub-Limits	The amount of ratio debt available to non-guarantors may be subject to a sub-limit. Shared sub-limits may be inserted.
7. Mandatory Prepayments	New lenders may participate in mandatory prepayments on a pro rata basis or less than pro rata basis (but no greater than pro rata basis).
8. Financial Covenants	No new financial maintenance covenant may be permitted, except if added for the benefit of the existing lenders with certain qualifications.

The existing lender protections summarized above are sometimes negotiated points or may exist based on the agreed precedent used in a given credit agreement. The differences may be principled in basis: for example, pricing MFN protection may be sensible for syndicated debt under the accordion but less applicable under the incremental-in-lieu basket (*i.e.*, different circumstances and not comparable markets), all the more so in connection with unitranche financing, a shareholder loan or bond offering. Other differences may evolve as legacy items that are not at the time considered material.

Notable Adjustments to the Accordion and Ratio Debt Prongs

When direct lenders consider investing into an existing structure, they may insist on a host of amendments to more firmly entrench their long-term interests and to limit dilution.

Syndicated credit agreements will likely give the borrower and new lenders the latitude to make lender-favorable adjustments subject to the terms' MFN provision and other protections discussed above, even if such incoming lenders will not constitute "Required Lenders" and hold a majority position of the loans. To preserve their likelihood of recovery and their tier in the capital structure, well-advised lenders will scrutinize whether amendments are appropriate; for example, by focusing on ratio levels, EBITDA adjustments, financial covenants, leakage to non-guarantors (including material intellectual property), anti-layering, guarantee/collateral release provisions and perhaps ROFOs with respect to incremental debt.

Direct lenders may also wish to alter the voting provisions in relation to the payment waterfall and pro rata sharing provisions and seek additional consent requirements for potential priming transactions in connection with repurchases of debt on a non-pro rata basis. The list of potential changes is varied and deal specific.

Assuming a general willingness to accommodate more restrictive terms, borrowers are often successful in the current credit climate countering with compromise language for operational and structural reasons and to prevent trip-wire defaults. For instance, in response to "J. Crew" blockers on transferring material intellectual property, "Material IP" could be limited to a main brand of the company or defined to be the material IP of the company and its subsidiaries, taken as a whole (as determined by the borrower in good faith) with other carve-outs that satisfy both parties' concerns. As another example, instead of a blanket sub-limit, new caps on non-guarantor debt can be confined to *debt for borrowed money* to afford foreign subsidiaries (outside the credit group) further room to incur capital leases. As part of discussions to add voting requirements, the parties may agree on certain "Serta" exceptions, including where existing lenders are offered a bona fide opportunity, on a pro rata basis, to provide additional debt on the same terms and conditions as new lenders. Application of other protections—such as maturity restrictions or a pricing MFN provision—could be tied to new debt in excess of an agreed threshold, as opposed to any debt under the accordion and ratio baskets.

Conclusion

Existing investors may expect certain protections built into the credit agreement from the original closing to keep them on an even keel with new lenders. Negotiated carve-outs and exceptions under the accordion and the negative covenants may belie those expectations. An important example is pricing MFN protection that may not translate into corresponding protection under other baskets. The same may be true for other protections that may not apply equally across the accordion, incremental in-lieu basket, ratio debt basket and acquisition debt basket, affording a borrower critical flexibility to structure a debt investment, including vis-à-vis a sidecar facility discussed above.

Direct lenders have been gaining leverage to obtain more attractive terms in light of today's challenging financing markets. As they collaborate to provide larger loans, they are seeing increased traction among both mid-size private equity firms and large-cap sponsors. As a general matter, direct lenders may expect different terms as part of their loans. Existing syndicated terms with respect to rules governing incremental and ratio debt have attracted a brighter spotlight as a consequence. Understanding the universe of incremental provisions and ratio debt will limit surprises for companies and lenders.

RAISING THE BAR ON DIVERSITY, EQUITY, AND INCLUSION

By Jaime Lizárraga

Jaime Lizárraga is a Commissioner at the Securities and Exchange Commission. The following is edited from remarks that he gave at the ICI Securities Development Conference on October 13, 2022.

The asset management industry's contribution to our country's financial security is undeniable. You have a direct impact on the financial futures of millions of working families. From grocery store workers, and other essential workers who invest part of their weekly paychecks in a 401(k) managed by a registered fund, to the single mother whose investment adviser helps her save for her daughter's higher education.

The industry's continuing growth is impressive by any measure. As of 2021, U.S.-registered fund assets totaled approximately $35 trillion and private fund assets totaled approximately $20 trillion. According to the Investment Adviser Association, registered investment advisers managed approximately $128 trillion in assets and served approximately 65 million clients. And by ICI's own estimate, almost 60 million U.S. households own mutual funds.

These numbers demonstrate the enormous wealth-building opportunities that the industry offers many working families and can offer to those who may not yet have been reached. And that is where diversity, equity and inclusion ("DEI") comes into the picture.

One of the most in-depth examinations of the state of DEI in the asset management industry was conducted by the SEC's Asset Management Advisory Committee ("AMAC"). This Committee conducted its work during Chairman Jay Clayton's tenure. One key finding, based on input from a wide range of stakeholders, including analysis of data provided by the ICI, was that investors increasingly deem DEI information material to their investment decisions.

AMAC, in its report, also cited an eye-opening 2017 statistic from the Government Accountability Office—the auditing arm of Congress: less than 1% of global assets under management, then $70 trillion, was managed by women- and minority-owned asset management firms.

By way of comparison, and according to the 2020 U.S. Census, nearly 40% of the U.S. population identifies as a member of a racial or ethnic group. And, women constitute slightly over half of the U.S. population.

While GAO's 1% statistic brings into focus the DEI challenge in the asset management space, it also represents an opportunity to reflect on the issue in the context of what it means to the investing public.

My involvement in DEI issues spans the entirety of my nearly 32 years in public service. The issue can be challenging and often controversial. And statistics like the 1%, when cited, can have the unintended effect of discouraging investment in solutions, out of concern for limited or no returns on that investment.

That is certainly not my intent here. Based on my longtime involvement with DEI issues, I'm keenly aware that progress can take time. The reality is that meaningful strides in advancing DEI takes a combination of commitment, leadership, and constructive engagement.

The Commission's own ongoing experience in the DEI space provides a useful perspective. And it's another way of conveying to you that you're not alone.

SEC Chair Gensler deserves much credit for his efforts to diversify the SEC's top leadership ranks. It was also great to see my fellow Commissioner Mark Uyeda recently deliver a thoughtful DEI keynote speech to the Association of Asian American Investment Managers. I'm encouraged by my fellow Commissioners' strong interest and commitment to DEI matters and I look forward to continuing our dialogue.

It has also been encouraging to engage with the Commission's Office of Minority and Women Inclusion: a product of the landmark Dodd-Frank Act. OMWI, as it's known, has made great strides in building a diverse pipeline, establishing partnerships with universities and high schools, fostering an inclusive workplace culture, providing mentorship and professional development opportunities, and several other critical initiatives.

But challenges remain. For instance, at nearly 6% of the SEC's workforce, Latinos and Latinas remain significantly underrepresented—compared to 9.5% of the federal workforce, and 13% of the civilian workforce. By comparison, the Latino community in our country is 63 million strong, and 19% of the U.S. population. In addition, other diverse groups, including people with disabilities and veterans, continue to be underrepresented in senior officer and other supervisory positions.

Despite these challenges, there are a few bright spots. The representation of certain diverse groups in these senior SEC positions is increasing steadily. On the asset management side, by some accounts, women- and minority-owned assets under management have been increasing over the years. Similarly, the representation of women on mixed-gender portfolio teams has grown.

It is also heartening to see many of the diversity initiatives undertaken by market participants, self-regulatory organizations, and industry trade associations. In fact, through its recently launched D&I RFP Framework, the ICI has worked to advance standardization and accountability on diversity and inclusion for its members.

In the face of deep challenges, many of these organizations have demonstrated a strong commitment to meaningful results. And many of them also recognize that an unwavering commitment is what it takes to tackle difficult DEI challenges.

Bearing in mind AMAC's conclusion about investor-driven materiality for DEI information, the optimist in me sees the 1% as enormous untapped potential—a future market opportunity that will likely continue to grow for some time. Of course, at the end of the day, you are the better judge of the validity of that intuitive statement. That said, AMAC's four recommendations are premised on the view that diversity serves the public interest, which they believe is central to the Commission's mission, and that investors increasingly deem DEI information as material to their investment decisions. To that end, AMAC recommended that the Commission:

- require investment advisers and funds to provide enhanced gender and racial diversity disclosures;
- issue Commission guidance for fiduciaries selecting other asset managers;
- establish a centralized mechanism for cataloging and maintaining records relating to discriminatory practices in the securities industry; and
- conduct a study of how the pay-to-play industry has evolved in light of over a decade having passed since the Commission last conducted a deep examination of pay-to-play practices.

[On October 12] the staff of the SEC provided guidance on fiduciaries selecting other asset managers, in the form of an FAQ document. However, the FAQ is difficult to find on our website and could have been accompanied by a public announcement alerting market participants of its existence.

To help move the needle on that 1% diversity statistic, we must do more. I strongly believe the Commission must consider whether AMAC's four recommendations can be fully implemented, at the Commission level. If that isn't possible, I believe it is our responsibility to the public to explain why.

Beyond AMAC's recommendations, the Commission recently released its Spring 2022 rulemaking agenda. That agenda includes planned rules relating to enhanced board diversity and human capital management disclosures. These rules, if proposed, represent an opportunity for investors to benefit from more meaningful, standardized and transparent diversity-related disclosures that would help them make more informed investment decisions.

In closing, as we continue to advance DEI priorities in our respective spaces, it is my hope that you'll consider today's remarks as constructive and helpful in informing your own efforts. I, for one, look forward to engaging with you and other stakeholders on the DEI challenges ahead and on ways that we can work together on our shared goals. Overall, I strongly believe that there are many benefits that result from a long-term commitment to advancing diversity, equity, and inclusion.

Addendum: SEC Staff FAQ Relating to Investment Adviser Consideration of DEI Factors

Q. Under its fiduciary duty, may an investment adviser that recommends other investment advisers to or selects other advisers for its clients consider factors relating to diversity, equity, and inclusion, provided that the use of such factors is consistent with a client's objectives, the scope of the relationship, and the adviser's disclosures?[1]

A. Yes. An investment adviser is required to have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives.[2] Such a reasonable belief that advice is in the best interest of the client typically includes consideration of a variety of factors.[3] Accordingly, an adviser that recommends other investment advisers to or selects other advisers for their clients may consider a variety of factors in making a recommendation or selection, including, but not limited to, factors relating to diversity, equity, and inclusion, provided that the use of such factors is consistent with a client's objectives, the scope of the relationship, and the adviser's disclosures.[4] Further, the adviser's fiduciary duty does not mandate restricting such a recommendation or selection to investment advisers with certain specified characteristics, such as a minimum amount of assets under management or a minimum length of track record.[5]

ENDNOTES:

[1]*See* https://www.sec.gov/tm/staff-faq-relating-investment-adviser-consideration-dei-factors. This staff FAQ represents the views of the staff of the Securities and Exchange Commission ("Commission") and is not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved this staff FAQ. The staff FAQ, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

[2]Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 FR 33669, at 33673 (June 5, 2019) ("Commission Interpretation").

[3]Commission Interpretation at 33674. ("[A]n adviser would not satisfy its fiduciary duty to provide advice that is in the client's best interest by simply advising its client to invest in the lowest cost (to the client) or least remunerative (to the investment adviser) investment product or strategy without any further analysis of other factors in the context of the portfolio that the adviser manages for the client and the client's objective.").

[4]In addition, certain investment advisers who also may be subject to regulation by the Department of Labor should consider such applicable laws and regulations when providing advice.

[5]*See also* SEC Asset Management Advisory Committee—Subcommittee on Diversity and Inclusion, Recommendations for Consideration by the AMAC (July 7, 2021), *available at* https://www.sec.gov/files/spotlight/amac/amac-report-recommendations-diversity-inclusion-asset-management-industry.pdf (discussing that the use of minimum independent selection criteria such as performance, size (AUM), and length of track record can have the effect of disproportionately excluding non-traditional or diverse-owned advisers).

SEC/SRO UPDATE: SEC CHARGES KIM KARDASHIAN FOR UNLAWFULLY TOUTING CRYPTO SECURITY; SEC ADOPTS AMENDMENTS TO MODERNIZE HOW BROKER-DEALERS PRESERVE ELECTRONIC RECORDS; SPARKSTER TO PAY $35 MILLION TO INVESTOR FUND FOR UNREGISTERED CRYPTO ASSET OFFERING; SEC CHARGES 16 WALL STREET FIRMS WITH RECORDKEEPING FAILURES; BITTREX SETTLES $53 MILLION IN FINES WITH TREASURY FOR SANCTIONS, AML VIOLATIONS

SEC Charges Kim Kardashian for Unlawfully Touting Crypto Security

On October 3, the SEC announced charges filed against the influencer/celebrity Kim Kardashian for promoting, on social media, a crypto asset security offered and sold by EthereumMax without disclosing that she had been paid for the promotion. Kardashian agreed to settle the charges and cooperate with the Commission's ongoing investigation.[1]

As per the SEC's order, Kardashian failed to disclose that she was paid $250,000 to publish a post on her Instagram account about EMAX tokens, EthereumMax's crypto asset security offering. Kardashian's post linked to the EthereumMax website, which provided instructions for potential investors to purchase EMAX tokens.

The SEC's order finds that Kardashian violated Section 17(b) of the Securities Act, which makes it "unlawful for any person to: publish, give publicity to, or circulate any notice . . . or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof."

Without admitting or denying the SEC's findings, Kardashian agreed to pay $1.26 million, including approximately $260,000 in disgorgement, which represents her promotional payment, plus prejudgment interest, and a $1 million penalty. Kardashian also agreed to not promote any crypto asset securities for three years.

In a statement, SEC Chair Gary Gensler said the case is "a reminder that, when celebrities or influencers endorse investment opportunities, including crypto asset securities, it doesn't mean that those investment products are right for all investors. Kardashian's case also serves as a reminder to celebrities and others that the law requires them to disclose to the public when and how much they are paid to promote investing in securities."

He pointed to the SEC's 2017 statement urging investor caution regarding potentially unlawful celebrity-backed crypto asset offerings:

> Celebrities and others are using social media networks to encourage the public to purchase stocks and other investments. These endorsements may be unlawful if they do not disclose the nature, source, and amount of any compensation paid, directly or indirectly, by the company in exchange for the endorsement . . . We encourage investors to research potential investments rather than rely on paid endorsements from artists, sports figures, or other icons.[2]

As per a *New York Times* article on the matter, however, Kardashian did include in the post a disclaimer that she wasn't offering financial advice, along with the hashtag #AD, which the FTC has endorsed as an indication that the post is a paid advertisement. "Kardashian's big mistake: she left out when and how much she was paid," as the *Times* noted.[3]

SEC Adopts Rule Amendments to Modernize How Broker-Dealers Preserve Electronic Records

On October 12, the SEC voted to adopt amendments to the electronic recordkeeping, prompt production of records, and third-party recordkeeping service requirements applicable to broker-dealers, security-based swap dealers ("SBSDs"), and major security-based swap participants ("MSBSPs"). Per the SEC, the amendments are intended to "modernize recordkeeping requirements given technological changes over the last two decades and to make the rule adaptable to new technologies in electronic recordkeeping." The amendments will also facilitate examinations of broker-dealers, SBSDs, and MSBSPs.[4]

Currently, the SEC's broker-dealer electronic recordkeeping rule requires firms to preserve electronic records exclusively in a non-rewriteable, non-erasable format (the "write once, read many" format). The new amendments offer an audit-trail alternative, under which electronic records can be preserved in a manner permitting the recreation of an original record if it is altered, over-written, or erased.

The SEC claimed the audit-trail alternative is designed to provide broker-dealers with greater flexibility when configuring electronic recordkeeping systems "so they more closely align with current electronic recordkeeping practices while also protecting the authenticity and reliability of original records."

The amendments also require broker-dealers and all types of SBSDs and MSBSPs to produce electronic records to securities regulators in a reasonably usable electronic format.

The adopting release will be published on SEC.gov and in the Federal Register. The final amendments will become effective 60 days after publication in the Federal Register. The compliance dates for the new requirements will be six months after publication in the Federal Register in the case of broker-dealers and 12 months after publication in the Federal Register in the case of SBSDs and MSBSPs.

Sparkster to Pay $35 Million to Harmed Investor Fund for Unregistered Crypto Asset Offering

On September 19, the SEC issued a cease-and-desist order against Sparkster Ltd. and its CEO, Sajjad Daya, for unregistered offer and sale of crypto asset securities between April 2018 and July 2018. At the same time, the Commission also charged crypto influencer Ian Balina for allegedly failing to disclose compensation he received from Sparkster for publicly promoting its tokens and failing to file a registration statement with the SEC for Sparkster tokens that he resold.[5]

Sparkster and Daya agreed to settle and to collectively pay more than $35 million into a fund for distribution to allegedly harmed investors.

As per the SEC's order, Sparkster and Daya raised $30 million from 4,000 global investors by offering and selling crypto asset securities called SPRK tokens to raise money to further develop Sparkster's "no-code" software platform. The SEC claimed Sparkster and Daya told investors that SPRK tokens would increase in value, that Sparkster management would continue to improve Sparkster, and the tokens would soon be made available on a crypto trading platform. The SPRK tokens, as offered and sold, were securities, as per the SEC, but were not registered with the SEC, and not applicable for a registration exemption.

The SEC's order finds that Sparkster and Daya violated the offering registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933. Without admitting or denying the SEC's findings, Sparkster agreed to destroy its remaining tokens, request that its tokens be removed from trading platforms, and publish the SEC's order on its website and social media channels. Without admitting or denying the SEC's findings, Daya agreed to refrain for five years from participating in offerings of crypto asset securities. The SEC ordered Sparkster to pay $30 million in disgorgement, $4,624,754 in prejudgment interest, and a $500,000 civil penalty. The SEC's order imposes a $250,000 civil penalty against Daya.

According to the SEC's complaint against Balina, which was filed in the United States District Court for the Western District of Texas, Balina allegedly purchased $5 million worth of SPRK tokens. He then, from roughly May to July 2018, promoted SPRK tokens on YouTube, Telegram, and other social media platforms while he allegedly failed to disclose that Sparkster would provide him a 30% bonus on the tokens that he purchased, as consideration for his promotional efforts.

Balina also allegedly organized an investing pool of at least 50 individuals to whom he offered and sold SPRK tokens, the SEC claimed. He undertook these actions despite not registering the offering, as required by federal securities laws, and despite the apparent lack of an applicable exemption from registration.

The SEC's complaint charges Balina with violating the offering registration provisions of Section 5(a) and (c) of the Securities Act and with violating Section 17(b) of the Act and seeks injunctive relief, disgorgement plus prejudgment interest, and civil penalties.

SEC Charges 16 Wall Street Firms with Widespread Recordkeeping Failures

On September 27, the SEC announced charges levied against 15 broker-dealers and one affiliated investment advisor for widespread, longstanding failures by the firms and their employees to maintain and preserve electronic communications.[6]

All of the named firms admitted the facts listed in their respective SEC orders and acknowledged that their conduct had violated recordkeeping provisions of federal securities laws. In total, the firms will pay penalties of more than $1.1 billion, and all firms have begun implementing improvements to their compliance policies and procedures.

The following eight firms (and five affiliates) agreed to pay penalties of $125 million each:

- Barclays Capital Inc.;
- BofA Securities Inc. (with Merrill Lynch, Pierce, Fenner & Smith Inc.);
- Citigroup Global Markets Inc.;
- Credit Suisse Securities (USA) LLC;
- Deutsche Bank Securities Inc. (with DWS Distributors Inc. and DWS Investment Management Americas, Inc.);
- Goldman Sachs & Co. LLC;
- Morgan Stanley & Co. LLC (with Morgan Stanley Smith Barney LLC); and
- UBS Securities LLC (with UBS Financial Services Inc.).

The following have agreed to pay penalties of $50 million each: Jefferies LLC, and Nomura Securities International, Inc. Cantor Fitzgerald & Co. has agreed to pay a $10 million penalty.

In its investigation, the SEC claimed it uncovered "pervasive off-channel communications," which occurred across all 16 named firms and which involved senior and junior investment bankers and debt and equity traders.

From January 2018 through September 2021, firms' employees routinely communicated about business matters via text messages on their personal devices. As per the SEC, their firms failed to maintain or preserve most of these off-channel communications, which is a violation of the federal securities laws. The SEC claimed that "by failing to maintain and preserve required records relating to their businesses, the firms' actions likely deprived the Commission of these off-channel communications in various Commission investigations."

The firms cooperated with the investigation by gathering communications from personal devices of a sample of each firm's personnel. Each of the 15 broker-dealers were charged with violating recordkeeping provisions of the Securities Exchange Act of 1934 and with failing reasonably to supervise with a view to preventing and detecting those violations. And investment adviser DWS Investment Management Americas, Inc. was charged with violating certain recordkeeping provisions of the Investment Advisers of 1940 and failing reasonably to supervise with a view to preventing and detecting those violations.

Along with financial penalties, all listed firms were ordered to cease and desist from future violations of the relevant recordkeeping provisions; all were censured. The firms also agreed to retain compliance consultants that will conduct comprehensive reviews of their policies and procedures relating to retaining and logging electronic communications found on personal devices. The consultants will also examine the firms' respective frameworks for addressing non-compliance by their employees with those policies and procedures.

Separately, the Commodity Futures Trading Commission announced settlements with the firms for related conduct.

"Today's actions—both in terms of the firms involved and the size of the penalties ordered—underscore the importance of recordkeeping requirements: they're sacrosanct. If there are allegations of wrongdoing or misconduct, we must be able to examine a firm's books and records to determine what happened," said Gurbir Grewal, Director of the SEC's Division of Enforcement, in a statement. "These 16 firms not only have admitted the facts and acknowledged that their conduct violated these very important requirements, but have also started to implement measures to prevent future violations. Other broker dealers and asset managers who are subject to similar requirements under the federal securities laws would be well-served to self-report and self-remediate any deficiencies."

"These actions deliver a straightforward message to registrants: You are expected to abide by the Commission's recordkeeping rules," added Sanjay Wadhwa, Deputy Director of Enforcement. "The time is now to bolster your record retention processes and to fix issues that could result in similar future misconduct by firm personnel."

Crypto Exchange Bittrex Settles $53 Million in Fines with Treasury Department for Sanctions, Anti-Money-Laundering Violations

On October 11, the U.S. Treasury Department announced that cryptocurrency exchange Bittrex, Inc. had settled $53 million in fines over allegations that it violated sanctions and anti-money-laundering laws. Treasury's Office of Foreign Assets Control ("OFAC") and Financial Crimes Enforcement Network ("FinCEN") had conducted parallel investigations into Bittrex's activities, and Bittrex settled with them.[7]

This is OFAC's largest virtual currency enforcement action to date and also represents the first parallel enforcement actions by FinCEN and OFAC in this space.

OFAC and FinCEN investigations found apparent violations of multiple sanctions programs and willful violations of the Bank Secrecy Act's ("BSA's") anti-money laundering ("AML") and suspicious activity report ("SAR") reporting requirements. These enforcement actions emphasize to the virtual currency industry the importance of implementing appropriate risk-based sanctions compliance controls and meeting obligations under the BSA. Failure to take action could expose exchanges and others in the virtual currency industry to potential abuse by illicit actors.

"For years, Bittrex's AML program and SAR reporting failures unnecessarily exposed the U.S. financial system to threat actors," said FinCEN Acting Director Himamauli Das, in a statement. "Bittrex's failures created exposure to high-risk counterparties including sanctioned jurisdictions, darknet markets, and ransomware attackers. Virtual asset service providers are on notice that they must implement robust risk-based compliance programs and meet their BSA reporting requirements. FinCEN will not hesitate to act when it identifies willful violations of the BSA."

OFAC Settlement with Bittrex

Bittrex agreed to remit roughly $24.3 million to OFAC to settle its potential civil liability for 116,421 apparent violations of multiple sanctions programs. Because of deficiencies related to its sanctions compliance procedures, Bittrex allegedly failed to prevent individuals apparently located in the Crimea region of Ukraine, Cuba, Iran, Sudan, and Syria from using its platform to engage in approximately $263,451,600 worth of virtual currency-related transactions between March 2014 and December 2017.

Applicable sanctions programs generally prohibit U.S. persons from engaging in transactions with these jurisdictions. Based on internet protocol ("IP") address information and physical address information collected about each customer at onboarding, Bittrex allegedly had reason to know that these users were located in jurisdictions subject to sanctions. At the time of the transactions, however, Bittrex was not screening this customer information for terms associated with sanctioned jurisdictions.

The Treasury Department said this situation highlights how important it is for crypto firms to maintain risk-based sanctions and anti-money-laundering compliance programs. The FinCEN Consent Order imposing the penalties stated that Bittrex's failure to implement proper internal controls "left its platform open to abuse by bad actors, including money launderers, terrorist financiers, and sanctions evaders."

FinCEN Settlement With Bittrex

Bittrex agreed to remit to FinCEN approximately $29 million for its willful violations of the BSA's AML program and SAR requirements. FinCEN will credit Bittrex's payment of $24 million as part of an agreement to settle potential liability with OFAC against the FinCEN levied penalties.

As per FinCEN's investigation, from February 2014 through December 2018, Bittrex failed to develop, implement and maintain an effective AML program, in violation of its obligations under the BSA. In particular, FinCEN said Bittrex failed to maintain adequate controls that were "reasonably designed" to comply with SAR filing requirements. Rather than employ transaction monitoring software, for instance, Bittrex allegedly used a small amount of minimally-trained staff to manually review transactions for suspicious activity.

Further, FinCEN described Bittrex's AML program as failing to appropriately address risks associated with its offered products and services, including anonymity-enhanced cryptocurrencies. Bittrex allegedly failed to file any SARs between February 2014 and May 2017, and allegedly failed to identify and block a significant number of transactions sent to or from sanctioned jurisdictions.

The Bittrex enforcement actions are a sign that Treasury is increasingly committed to making companies take responsibility for AML and SAR requirements. It shows that such responsibility doesn't end when the company uses a third-party vendor for

OFAC compliance, as Bittrex did. Regardless of whether they employ a vendor to handle compliance, the onus remains on the company.

ENDNOTES:

[1] https://www.sec.gov/litigation/admin/2022/33-11116.pdf.

[2] https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos.

[3] https://www.nytimes.com/2022/10/04/business/dealbook/kardashian-crypto-sec-gensler-ethereummax.html.

[4] https://www.sec.gov/news/press-release/2022-187.

[5] https://www.sec.gov/news/press-release/2022-167.

[6] https://www.sec.gov/news/press-release/2022-174.

[7] https://home.treasury.gov/news/press-releases/jy1006.

FROM THE EDITOR

Trying to Keep One's Footing

As 2022 nears its close, the damage from the worst market conditions in over a decade grows ever more visible. By the end of September, all three major U.S. market indexes had gone deep into bear market territory. The S&P 500 has posted its worst performance since 2002—falling by more than 9% in September alone. Many retirement accounts have been battered since the year began.

In mid-October, there were signs of a potential equities rally: the S&P 500 and Dow gained 4.7% and 4.9%, respectively, while the Nasdaq rose 5.2%. The week of October 17 was the best week since June for all three major averages, although this occurred when the 10-year Treasury yield was at its highest level since the Great Recession in 2008. Few market observers were optimistic the rally would be long-lived.

These sort of whipsaw, out-of-nowhere market movements have come to define the year. At a time of historically high inflation, at a time when the United Kingdom has had three prime ministers in less than two months, volatility and unforeseen chaos from all quarters is now the expected. "Literally, the only bull market in the world right now is the bull market for cash," Julian Emanuel, who runs portfolio strategy at Evercore ISI, told NPR at the end of September.

Inflation remains a key determining factor. The Fed, the Bank of England and the European Central Bank are all hiking rates aggressively, at a pace that hasn't been seen in decades. The past has returned with a vengeance. There are traders on Wall Street today who have never experienced three-quarter-point hikes by the Fed before, much as there are new homebuyers who have never before seen fixed-rate mortgages top 8%. The only prediction that seems valid at this point is that more unforeseen, unimagined events will happen this year.

Our SEC Update this month leads with a recent high-profile case: Kim Kardashian's $1.26 million crypto-related settlement, which prompted SEC Chair Gary Gensler to post an "influencer-style" video warning about crypto scams. Kardashian's big mistake was not to list how much she was getting paid to promote crypto, which had some crypto analysts wondering if the Fed would go after Hollywood actors who touted similar products on Superbowl ads, without disclosing their fees. Again, stranger things have happened in 2022.

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