Annual Review of Federal Securities Regulation

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

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Introduction

This Annual Review ("Review") was prepared by the Subcommittee on Annual Review of the Committee on Federal Regulation of Securities of the ABA Business Law Section. The Review covers significant developments in federal securities law and regulation during 2018. The Review is divided into three sections: regulatory actions, accounting statements, and caselaw developments.

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

During 2018, the U.S. Securities and Exchange Commission (the "Commission") continued to devote significant resources to rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] In particular, substantial time was devoted to actions necessary to implement the requirements of Title VII of the Dodd-Frank Act in order to regulate the markets for security-based swaps.

During 2018, the Commission also focused on rulemaking that is consistent with the Commission's Disclosure Effectiveness initiative, and that is intended to promote capital formation.

Generally, the Review does not discuss proposed regulations or rules that are narrowly focused. For example, the Review generally does not address regulation of over-the-counter derivatives, hedge fund, and other private fund related rulemaking, or rulemaking related to registered investment companies, registered investment advisers, broker-dealers, or municipal advisors. Cases are chosen for both their legal concept as well as factual background. While the Subcommittee tries to avoid making editorial comments regarding regulations, rules, or cases, we have attempted to provide a practical analysis of the impact of the developments in the law and regulations on the day-to-day practice of securities lawyers.

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

Regulatory Developments 2018

A. Changes to Definition of Smaller Reporting Company

1. Overview

Rules of the Commission allow registrants that qualify as "smaller reporting companies" to provide certain scaled disclosures in registration statements, periodic reports, and other filings made with the Commission under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act").[1] In 2016, the Commission proposed to revise its rules to increase the public float and revenue thresholds for qualification as a smaller reporting company.[2] As proposed, for initial and continuing qualification as a smaller reporting company, the public float threshold would have increased from $75 million to $250 million and the revenue threshold for registrants with no public float would have increased from $50 million to $100 million.[3] The proposal also would have increased the lower thresholds for subsequent qualification for registrants that previously did not qualify as smaller reporting companies.[4] The Commission explained that the proposal would increase the number of registrants that qualified as smaller reporting companies eligible to provide scaled disclosures, thereby attempting to serve the goals of promoting capital formation and reducing compliance costs for smaller registrants, while maintaining investor protections.[5] The Commission indicated the proposal was responsive to recommendations and comments provided to the Commission by various advisory committees, forums, and staff reports and initiatives over the last few years.[6]

1. The definition of smaller reporting company is set forth in Item 10(f) of Regulation S-K (17 C.F.R. § 229.10(f)), Rule 405 under the Securities Act (17 C.F.R. § 230.405), and Rule 12b-2 under the Exchange Act (17 C.F.R. § 240.12b-2). Item 10(f) of Regulation S-K also indexes the scaled disclosure requirements that appear in various items throughout Regulation S-K.

2. Amendments to Smaller Reporting Company Definition, Release No. 33-10107, 81 Fed. Reg. 43130 (proposed July 1, 2016) (to be codified at 17 C.F.R. pts. 229, 230 & 240).

3. *Id.* at 43135.

4. *Id.*

5. *Id.* at 43132.

6. *Id.* at 43132–34. In particular, the Commission cited the recommendations of its Advisory Committee on Small and Emerging Companies in 2013 and 2015 and of the SEC Government-Business Forum on Small Business Capital Formation in 2015.

2. Final Rules

On June 28, 2018, the Commission adopted final rules revising the definition of "smaller reporting company."[7] The final rules increase the public float and revenue thresholds as proposed, and, in addition, allow registrants with a public float of less than $700 million to qualify as smaller reporting companies if their revenue is below the threshold.[8] Previously, only registrants with no public float could qualify based on the revenue test. The definitions of "accelerated filer" and "large accelerated filer" were revised so that the increased thresholds for smaller reporting company qualification *did not* result in an increase to the accelerated filer and large accelerated filer status thresholds.[9] The final rules became effective September 10, 2018.[10]

(a) Smaller Reporting Company Definition

(i) Public Float Test

The final rules amended the definition of "smaller reporting company" so that registrants with a public float of less than $250 million qualify as smaller reporting companies, regardless of their revenue.[11] However, as was the case prior to the amendments, once a registrant has determined that it does not qualify as a smaller reporting company, it must meet a lower threshold for subsequent qualification as a smaller reporting company under the public float test. The final rules set this lower, subsequent qualification public float threshold at $200 million, or 80 percent of the initial qualification threshold.[12] Once a registrant qualifies as a smaller reporting company by having a public float of less than $200 million, it would remain a smaller reporting company until its public float equals or exceeds the initial and continuing qualification threshold of $250 million.[13] As the Commission explained, the subsequent qualification threshold is designed to limit entry and exit from smaller reporting company status due to small fluctuations in public float.[14]

The amendments did not change the method of calculating public float or the timing of that determination.[15]

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7. Smaller Reporting Company Definition, Release No. 33-10513, 83 Fed. Reg. 31992 (July 10, 2018) (to be codified at 17 C.F.R. pts. 210, 229, 230, 239, 240 & 249) [hereinafter SRC Adopting Release].

8. *Id.* at 31995.

9. *Id.* at 31992–93.

10. *Id.* at 31992.

11. *Id.* at 31995–96 (to be codified at 17 C.F.R. §§ 229.10(f), 230.405, 240.12b-2).

12. *Id.*

13. *Id.* at 31996 (see discussion at note 58).

14. *Id.*

15. *See* 17 C.F.R. §§ 229.10(f), 230.405, 240.12b-2 (2019).

(ii) Revenue Test

The final rules also amended the definition of "smaller reporting company" so that registrants with annual revenue of less than $100 million during their most recently completed fiscal year and either no public float or a public float of less than $700 million qualify as smaller reporting companies.[16] Previously, only registrants with no public float were eligible for qualification under the revenue test.

As with the public float test discussed above, the revenue test includes lower subsequent qualification thresholds that registrants must meet if they previously did not qualify as a smaller reporting company. Consistent with the public float test discussed above, these subsequent qualification thresholds are set at 80 percent of the initial qualification thresholds—$80 million of revenue and $560 million of public float.[17] If a registrant previously did not qualify as a smaller reporting company under the revenue test because it exceeded only one of the two thresholds, and continued to satisfy the other threshold, then the lower subsequent qualification threshold would only apply to the previously exceeded threshold.[18] For example, if a registrant's annual revenue equaled or exceeded $100 million as of its prior determination date and its public float remained below $700 million, then it would be subject to the lower subsequent qualification revenue threshold at its next annual determination date, but would not be subject to the lower subsequent qualification public float threshold. If the registrant did not qualify as a smaller reporting company because it exceeded both the revenue and public float thresholds, then it would be subject to both lower subsequent qualification thresholds at its next annual determination date.

As noted above, the amendments did not change the method of calculating public float or revenue or the timing of the determinations, which for public float is as of the last business day of second fiscal quarter (in the case of an annual determination for a reporting registrant) and for revenue is based on the most recent fiscal year for which audited financial statements are available.[19]

3. Rule 3-05(b)(2)(iv) of Regulation S-X

Rule 3-05 of Regulation S-X sets forth the requirements for presentation of financial statements of acquired businesses.[20] In circumstances where a full three fiscal years of acquired business financial statements would otherwise be required, Rule 3-05(b)(2)(iv) allows registrants to omit the earliest of the three years when the acquired business's net revenue for its most recent fiscal year was less than a specified amount.[21] Historically, this specified amount was $50 million, aligning with the prior revenue threshold for determining smaller

16. SRC Adopting Release, *supra* note 7, at 31997–98 (to be codified at 17 C.F.R. §§ 229.10(f), 230.405, 240.12b-2).
17. *Id.*
18. *Id.* at 31998.
19. *See* 17 C.F.R. §§ 229.10(f), 230.405, 240.12b-2 (2019).
20. *See id.* § 210.3-05.
21. *See id.* § 210.3-05(b)(2)(iv).

reporting company status. The final rules amended Rule 3-05(b)(2)(iv) to increase the specified amount to $100 million to maintain the alignment with the increased revenue threshold in the smaller reporting company definition.[22]

4. Accelerated Filer and Large Accelerated Filer Definitions

Prior to the adoption of the final rules, the definitions of "accelerated filer" and "large accelerated filer" in Rule 12b-2 under the Exchange Act excluded registrants that qualified as smaller reporting companies.[23] If these definitions had not been amended, then the thresholds for accelerated filer and large accelerated filer status would have been indirectly increased as a result of the revisions to the definition of smaller reporting company. However, the Commission revised the definitions of accelerated filer and large accelerated filer to remove the language excluding smaller reporting companies, thereby preserving the existing public float thresholds for accelerated filer and large accelerated filer status.[24]

As a result of the final rules, there will now be a category of registrants that are both accelerated filers and smaller reporting companies because their public float exceeds $75 million, but remains below either $250 million or $700 million if their revenue is below $100 million.[25] There may also be very limited circumstances where a registrant is a large accelerated filer and a smaller reporting company.[26] The Commission acknowledged in the SRC Adopting Release that eliminating the historical alignment between smaller reporting company and non-accelerated filer status creates regulatory complexity.[27] The Commission staff has been directed to consider this relationship in formulating recommendations regarding potential rule changes to reduce the number of accelerated filers.[28]

The final rules also amended the cover pages of various forms under the Securities Act and Exchange Act in order to delete a parenthetical next to the non-accelerated filer check box that indicated "do not check if a smaller reporting company."[29] As a result of the final rules, registrants should check all applicable boxes that apply to indicate their status as a large accelerated filer, an accelerated filer, a non-accelerated filer, a small reporting company, or an emerging growth company.[30]

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22. SRC Adopting Release, *supra* note 7, at 31999 (to be codified at 17 C.F.R. § 210.3-05(b)(2)(iv)).
23. *Id.*
24. *Id.* at 32001 (to be codified at 17 C.F.R. § 240.12b-2).
25. *Id.* at 32000–01. These registrants will be eligible to provide scaled disclosures as smaller reporting companies, but will be subject to accelerated filer filing deadlines. In addition, as accelerated filers, these registrants (other than emerging growth companies) will be subject to the requirement to obtain an auditor attestation report on internal control over financial reporting. 17 C.F.R. § 229.308(b) (2019).
26. SRC Adopting Release, *supra* note 7, at 32000–01 (see discussion at note 128).
27. *Id.* at 32001.
28. *Id.*
29. *Id.* at 32001 n.131. The amended forms are Securities Act Forms S-1, S-3, S-4, S-8, and S-11 and Exchange Act Forms 10, 10-Q, and 10-K.
30. *Id.*

B. Amendment of Rule 701(e) Threshold for Compensatory Offerings

As mandated by the Economic Growth, Regulatory Relief, and Consumer Protection Act,[31] on July 18, 2018, the Commission amended[32] Rule 701(e)[33] under the Securities Act to increase the aggregate sales price or amount of securities sold during any consecutive twelve-month period from $5 million to $10 million.[34] Except for the increase in the aggregate sales price or amount of securities sold under Rule 701(e), the amendment does not change the operation of Rule 701.[35] This amendment became effective on July 23, 2018.[36]

Rule 701 provides an exemption from the registration requirements of the Securities Act for securities issued in compensatory circumstances to specified investors (i.e., officers, directors, employees, and consultants) by companies that are not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act.[37] If the aggregate sales price or amount of securities sold in a consecutive twelve-month period exceeds the threshold provided by Rule 701(e), the company must deliver specified disclosures to investors within a reasonable period of time before the date of sale.[38] These additional disclosures, which can be quite burdensome for some companies to prepare, include a summary plan description of the compensatory plan or a summary of the material terms of the plan, including information about risks of the investment, and financial statements as of a date no more than 180 days before the sale of securities in reliance on Rule 701.[39] Some companies may avoid making compensatory offerings if the additional disclosure under Rule 701(e) would be triggered out of the concern that confidential information regarding the company will fall into the hands of competitors.

Private companies that rely on Rule 701 to offer securities on a compensatory basis to officers, directors, employees, and consultants may seek to increase the size of their programs, while remaining at a level where they would not need to incur the expenses of additional required disclosures.

In addition to amending Rule 701(e), the Commission issued a concept release[40] seeking public comment on ways to modernize compensatory securities offerings and sales focusing on Rule 701 and Form S-8 in light of the fact that

31. Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

32. Exempt Offerings Pursuant to Compensatory Arrangements, Release No. 33-10520, 83 Fed. Reg. 34940 (July 24, 2018) (to be codified at 17 C.F.R. § 230.701(e)) [hereinafter Exempt Offerings Adopting Release].

33. 17 C.F.R. § 230.701(e) (2019).

34. Exempt Offerings Adopting Release, *supra* note 32, at 34941 (to be codified at 17 C.F.R. § 230.701(e)).

35. *Id.*

36. *Id.* at 34940.

37. *Id.* at 34941.

38. *Id.*

39. *Id.*

40. Concept Release on Compensatory Securities Offerings and Sales, Release No. 33-10521, 83 Fed. Reg. 34958 (July 24, 2018) (to be codified at 17 C.F.R. pt. 230).

"[s]ignificant evolution has taken place both in the types of compensatory offerings issuers make and the composition of the workforce" since the Commission last substantively amended Rule 701.[41]

C. Disclosure Amendments

1. Overview

On August 17, 2018, the Commission amended certain disclosure requirements that it determined to be redundant, duplicative, overlapping, outdated, or superseded in light of other SEC disclosure requirements, U.S. generally accepted accounting principles ("U.S. GAAP"), or changes in the information environment.[42] The Commission initially proposed these amendments as part of its Disclosure Effectiveness Initiative[43] and, subsequently, was required by the Fixing America's Surface Transportation (FAST) Act[44] to undertake a study regarding Regulation S-K disclosure requirements. In addition, a number of other Commission-proposed amendments relating to the Commission's Industry Guides and other disclosure requirements await Commission action. As a result, these amendments should be considered as another incremental step in what may be a more comprehensive effort to reduce or modify disclosure requirements that may be viewed as burdensome or outdated.

In connection with this series of amendments, some disclosure requirements have been modified, eliminated, or consolidated with other disclosure requirements. These amendments, which became effective November 5, 2018, include revisions to Regulation S-K (the integrated disclosure rules applicable to domestic issuers as well as foreign private issuers that elect to make filings with the SEC on forms used by domestic issuers)[45] and Regulation S-X (the rules detailing the form and content of financial statements)[46] and impact Commission filings, including quarterly and annual reports, as well as registration statements for securities offerings. The Commission also referred certain disclosure requirements to the Financial Accounting Standards Board (the "FASB") for potential incorporation into U.S. GAAP.

According to the adopting release, the disclosure update and simplification amendments "are intended to facilitate the disclosure of information to investors and simplify compliance without significantly altering the total mix of information provided to investors."[47] Nevertheless, these amendments impact a large number of SEC rules, regulations, and forms, including as noted below.

41. *Id.* at 34958.
42. Disclosure Update and Simplification, Release No. 33-10532, 83 Fed. Reg. 50148 (Oct. 4, 2018) (to be codified at 17 C.F.R. pts. 210, 229, 230, 239, 240, 249 & 274) [hereinafter Disclosure Update Release].
43. Disclosure Update and Simplification, Release No. 33-10110, 81 Fed. Reg. 51607 (proposed Aug. 4, 2016) (to be codified at 17 C.F.R. pts. 210, 229, 230, 239, 240, 249 & 274).
44. Fixing America's Surface Transportation Act, Pub. L. No. 114-94, 129 Stat. 1313 (2015).
45. *See* 17 C.F.R. § 229 (2019).
46. *See id.* § 210.
47. Disclosure Update Release, *supra* note 42, at 50148.

2. Business Disclosure

The amendments that changed business section disclosure requirements include:

- Deletion of the requirement set forth in Item 101 of Regulation S-K[48] to include, if material, the amount spent on research and development activities, with the Commission noting that disclosure of material trend information related to research and development activities and expenses is required to be included in management's discussion and analysis of financial condition and results of operations (MD&A) of Item 303 of Regulation S-K;[49]
- Deletion of the Item 101 requirement to disclose segment financial information, with the Commission observing that these disclosures will continue to be available in notes to the financial statements;[50]
- Deletion of the Item 101 requirement to disclose financial information by geographic area, with an explicit reference to "geographic areas" added to the MD&A disclosure requirement;[51]
- Retention of Item 101 requirement to provide seasonality disclosure at the segment level to the extent material to understanding the business as a whole (although the Commission deleted instruction 5 to Item 303(b) of Regulation S-K relating to the MD&A seasonality disclosure in interim periods because U.S. GAAP and the balance of Item 303 require interim disclosures that convey similar information);[52]
- Deletion of the Item 101 requirement to identify the SEC's public reference room; and
- Expansion of the Item 101 requirement to disclose issuer website addresses of all issuers that have one.

3. Market Price and Dividend Disclosure

The amendments that changed market price and dividend disclosure requirements include:

- Deletion of the requirement to disclose high and low common stock trading prices for the past two years for most issuers;[53]

48. *Id.* at 50162 (to be codified at 17 C.F.R. § 229.101).
49. *Id.*
50. *Id.* at 50168 (to be codified at 17 C.F.R. § 229.101).
51. *Id.* at 50169 (to be codified at 17 C.F.R. § 229.101).
52. *Id.*
53. *Id.* at 50178 (to be codified at 17 C.F.R. § 229.101).

- Deletion of the requirements to disclose the amount and frequency of cash dividends declared from Item 201 of Regulation S-K,[54] with Rule 3-04 of Regulation S-X[55] amended to require disclosure of the amount of dividends in interim periods;[56]
- Consolidation of the Item 201 requirement to disclose restrictions on dividends into revised Rule 4-08 of Regulation S-X;[57] and
- Replacement of detailed disclosure of sale or bid prices previously required by Item 201 with the trading symbol for most companies whose common equity is traded in a public trading market.[58]

4. Ratio of Earnings to Fixed Charges

The amendments deleted the requirement to disclose the ratio of earnings to fixed charges from Item 503 of Regulation S-K[59] and deleted the related exhibit requirement in Item 601 of Regulation S-K.[60] To clarify that the ratio of earnings to fixed charges is not required in registration statements under the Securities Act, corresponding changes were made to delete the reference to that ratio from the titles of items in Commission forms that refer to Item 503, such as Item 3 of both Form S-1[61] and Form S-3.[62]

5. Regulation S-X

The disclosure update and simplification amendments involve more than fifty changes or referrals to the FASB of Regulation S-X rules, including amendments to avoid overlapping disclosure requirements, referrals to the FASB for consideration in upcoming FASB rulemaking,[63] and corrections to superseded requirements. The Regulation S-X amendments generally relate to domestic issuers and to foreign private issuers that either report under U.S. GAAP or a comprehensive body of accounting principles other than U.S. GAAP or International Financial

54. *Id.* at 50166 (to be codified at 17 C.F.R. § 229.201).
55. *Id.* (to be codified at 17 C.F.R. § 210.3-04).
56. *Id.*
57. *Id.* at 50171 (to be codified at 17 C.F.R. § 210.4-08).
58. *Id.* at 50177 (to be codified at 17 C.F.R. § 229.201).
59. *Id.* at 50165 (to be codified at 17 C.F.R. § 229.503).
60. *Id.* (to be codified at 17 C.F.R. § 229.601).
61. *See id.* (to be codified at 17 C.F.R. § 239.11); *SEC Form S-1*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/forms-1.pdf (last modified Sept. 2018) (noting OMB expiration date of July 31, 2021).
62. *See* Disclosure Update Release, *supra* note 42, at 50165 (to be codified at 17 C.F.R. § 239.13); *SEC Form S-3*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/forms-3.pdf (last modified Sept. 2018) (noting OMB expiration date of July 31, 2021).
63. The Commission has requested that the FASB determine whether referred disclosure items will be added to the FASB's agenda for potential standard setting by April 4, 2020, eighteen months after the adopting release was published in the *Federal Register*. *See* Disclosure Update Release, *supra* note 42, at 50153.

Reporting Standards with a reconciliation to U.S. GAAP. A few examples of these Regulation S-X changes include:

- Deletion of the requirement for pro forma interim financial information for business combinations in Rule 8-03[64] and 10-01[65] of Regulation S-X, with the Commission relying on U.S. GAAP and Item 9.01 of Form 8-K[66] to generate similar disclosures;
- Deletion of the requirement in Regulation S-X to disclose, in interim financial statements, material events subsequent to the end of the most recent fiscal year in light of similar disclosures that result from compliance with a combination of U.S. GAAP and Item 303(b) of Regulation S-K;[67]
- Retention of the requirement of Rule 4-07 Regulation S-X[68] to present a discount on shares in a manner that is incremental to U.S. GAAP requirements, while referring this Regulation S-X disclosure requirement to the FASB for potential incorporation into U.S. GAAP; and
- Deletion of the requirements in Rule 8-03[69] and Rule 10-01[70] of Regulation S-X to present dividends per share on the face of the income statement for interim periods because U.S. GAAP prohibits this disclosure on the face of the financial statements (but permits it in the notes to the financial statements).

6. Amendments for Specific Issuer Categories

Some of the disclosure update and simplification amendments apply only to specific categories of issuers, such as amendments to Commission forms that only affect the types of issuers using such forms. For example, because exchange rate information is readily available for free on a number of websites, the Commission amended Form 20-F,[71] which is used by foreign private issuers, to delete the requirement for such issuers to provide exchange rate data when financial statements are prepared in a currency other than the U.S. dollar.

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64. Disclosure Update Release, *supra* note 42, at 50165 (to be codified at 17 C.F.R. § 210.8-03).
65. *Id.* (to be codified at 17 C.F.R. § 210.10-01).
66. *Id.* at 50167 (to be codified at 17 C.F.R. § 249.308); *SEC Form 8-K*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/form8-k.pdf (last modified Apr. 2017) (noting OMB expiration date of July 31, 2021).
67. Disclosure Update Release, *supra* note 42, at 50169 (to be codified at 17 C.F.R. § 229.303).
68. *Id.* at 50172 (to be codified at 17 C.F.R. § 210.4-07).
69. *Id.* at 50180 (to be codified at 17 C.F.R. § 210.8-03).
70. *Id.* (to be codified at 17 C.F.R. § 210.10-).
71. *Id.* at 50179; *see* 17 C.F.R. § 249.220f (2019); *SEC Form 20-F*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/form20-f.pdf (last modified Apr. 2017) (noting OMB expiration date of July 31, 2021).

D. SEC Expands Safe Harbor to Promote Research on Investment Funds

1. Overview

On November 30, 2018, the Commission adopted a new rule[72] establishing a non-exclusive research report safe harbor ("Rule 139b") for unaffiliated brokers or dealers that publish or distribute research reports[73] regarding qualifying investment funds. The Commission took this action in furtherance of the rulemaking mandate of the Fair Access to Investment Research Act of 2017 (the "FAIR Act").[74] The FAIR Act required that the Commission expand the Rule 139 safe harbor for research reports in order to cover research reports on certain investment funds.[75]

The research safe harbor is now available for research reports regarding qualifying mutual funds, exchange traded funds, registered closed-end funds, business development companies ("BDCs"),[76] and similar covered investment funds.[77] Under the new safe harbor, the publication or distribution of a research report would not be deemed to constitute an "offer" under the Securities Act of the qualifying covered investment fund's securities.[78] The safe harbor is available even if the broker-dealer is participating in or may participate in a registered offering of the covered investment fund's securities.[79] Adoption of this safe harbor reduces obstacles that previously prevented investors from accessing research reports on investment funds.[80]

2. Issuer-Specific Research Reports

An unaffiliated broker-dealer may release an issuer-specific research report in reliance on the Rule 139b safe harbor if the covered investment fund meets the

72. *See generally* Covered Investment Fund Research Reports, Release No. 33-10580, 83 Fed. Reg. 64180 (Nov. 30, 2018) (to be codified at 17 C.F.R. § 230.139b) [hereinafter Covered Fund Adopting Release].

73. The term "research report" is defined as a written communication that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security of an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision. The definition is the same as the current definition of "research report" in 17 C.F.R. § 230.139(d) (2019). *Id.* at 64183 (to be codified at 17 C.F.R. § 230.139b).

74. *Id.* at 64180–81; *see generally* Fair Access to Investment Research Act of 2017, Pub. L. No. 115-66, 131 Stat. 1196 (2017).

75. Covered Fund Adopting Release, *supra* note 72, at 64181.

76. *See id.* at 64183 (to be codified at 17 C.F.R. § 139b(c)(2)). The Securities Act already provides a safe harbor for broker-dealers with respect to research reports about "emerging growth companies," as defined in section 2(a)(19) of the Securities Act. *See id.* at 64181 n.6.

77. *See id.* at 64183 (to be codified at 17 C.F.R. § 230.139b(c)(2)).

78. *See id.* at 64181 n.16 (to be codified at 17 C.F.R. § 230.139b(a)). *Compare* 15 U.S.C. § 77b(a)(10)-5(c) (2018) (publication of research reports are no longer considered "offers" under Rule 139b).

79. *See* Covered Fund Adopting Release, *supra* note 72, at 64181 n.16 (to be codified at 17 C.F.R. § 230.139b(a)).

80. *See generally id.*

specified reporting history and timeliness requirements.[81] Consistent with the condition in Rule 139, the covered investment fund must be subject to the public company reporting requirements of the Exchange Act,[82] for at least twelve months prior to reliance on the safe harbor, and must also have timely filed its periodic reports (including those on Forms 10-K and 10-Q) with the Commission during such time period.[83]

The public reporting history and timeliness requirements prevent the safe harbor from being extended to research reports relating to newly public funds and require the relying broker-dealer to confirm the timeliness of the covered investment fund's Exchange Act filings.[84] In the adopting release, the Commission acknowledged that a broker-dealer may rely on the lack of a Form 12b-25 filing (Notification of a Late Filing)[85] as confirmation that a fund's filings are timely unless the broker-dealer is actually aware through other means that the issuer has not in fact made timely Exchange Act filings.[86]

The covered investment fund must also have a minimum public market value (or net asset value for mutual funds) of at least $75 million (consistent with Form S-3's eligibility requirement).[87] BDCs and closed-end funds are not permitted to satisfy the float requirement using a net asset value calculation.[88] The requirement must be satisfied upon the initiation of research coverage and quarterly thereafter so long as the broker-dealer is continuing to issue research on the fund.[89] Importantly, the rule does not require that the market value or net asset value be calculated to exclude affiliate holdings for most covered investment funds.[90] Unfortunately, the presence of a minimum public float requirement prevents the safe harbor from being used in the case of smaller public issuers and non-traded BDCs and, as a consequence, may limit an investor's fair access to investment research covering such issuers.[91]

81. *See* Covered Investment Fund Research Reports, Release No. 33-10498, 83 Fed. Reg. 26788, 26795 n.77 (proposed May 23, 2018) (to be codified at 17 C.F.R. § 230.139b) [hereinafter Covered Fund Proposing Release].

82. 15 U.S.C. §§ 78a–78qq (2018).

83. *See* Covered Fund Adopting Release, *supra* note 72, at 64184 n.66 (to be codified at 17 C.F.R. § 230.139b(a)(1)(i)(A)).

84. *See id.* at 64184 (including discussion at note 51).

85. *See id.* at 64186.

86. *Id.*

87. *Id.*; *see also* 17 C.F.R. § 239.13 (2019); *SEC Form S-3*, U.S. Sec. & Exchange Commission, https://www.sec.gov/about/forms/forms-3.pdf (last modified Sept. 24, 2014) (General Instruction I.B.1).

88. *See* Covered Fund Adopting Release, *supra* note 72, at 64188–89 (to be codified at 17 C.F.R. § 230.139b(a)(1)(i)(B)).

89. *Id.* at 64188 (to be codified at 17 C.F.R. § 230.139b(a)(1)(i)(B)).

90. *Id.* at 64187–88 (to be codified at 17 C.F.R. § 230.139b(a)(1)(i)(B)) ("Unlike rule 139, rule 139b does not permit affiliates of covered investment funds to rely on the safe harbor . . . .").

91. *See* Covered Fund Proposing Release, *supra* note 81, at 26796 (indicating an intent to create a framework with a limit on the amount of research on covered investment funds). If a smaller issuer does not satisfy the public float requirement, a broker-dealer participating in a securities offering may consider a Rule 482 communication. *See generally* 17 C.F.R. § 230.482 (2019).

Consistent with Rule 139, the research report must be published or distributed by the broker-dealer in its regular course of business.[92] The Commission noted that a broker-dealer can satisfy the regular course of business requirement if at the time of reliance on the safe harbor it has previously distributed or published at least one research report about the covered issuer or its securities.[93] However, unlike Rule 139, the research report may represent the initiation or re-initiation of research covering the investment fund so long as such fund's securities are in substantially continuous distribution.[94] The Commission's adopting release notes that the substantially continuous distribution threshold is an analysis based on a given issuer's particular facts and circumstances without providing any meaningful additional clarity.[95]

3. Industry Research Reports

Similar to the issuer-specific research report requirement, the Rule 139b safe harbor requires each covered investment fund that is included in an industry research report to be subject to the public reporting requirements of the Exchange Act (or section 30 of the Investment Company Act of 1940, as amended, for registered investment companies).[96] The regular course of business requirement for issuer-specific research reports described above similarly applies to industry research reports.[97]

The industry research report safe harbor is also conditioned on certain content requirements.[98] In particular, industry research reports either must include similar information about a substantial number of covered investment funds of the same type or investment focus or alternatively contain a comprehensive list of covered investment fund securities currently recommended by the broker dealer.[99] The industry research report is required to include similar information about a substantial number of issuers either of the same type (e.g., exchange traded-funds or mutual funds that are large cap funds, bond funds, balanced funds, or money market funds) or investment focus (e.g., primarily invested in the same industry or sub-industry, or the same country or geographic region).[100]

Also, the industry research report safe harbor is conditioned on a presentation requirement.[101] Under Rule 482(b), analysis of any covered investment fund included in an industry research report cannot be given materially greater space or

92. *See* Covered Fund Adopting Release, *supra* note 72, at 64208 (to be codified at 17 C.F.R. § 230.139b).

93. *See id.* at 64189.

94. *See id.* at 64189; 17 C.F.R. § 230.139(a)(1)(iii) (2019). *Compare* Fair Access to Investment Research Act, Pub. L. No. 115-66, § 2(b)(1), 131 Stat. 1196, 1196 (2017). The FAIR Act expands the safe harbor to allow reports that cover periods not covered by Rule 139.

95. *See* Covered Fund Adopting Release, *supra* note 72, at 64189.

96. *See id.* at 64190.

97. *See id.* at 64190 (to be codified at 17 C.F.R. § 230.139b(a)(2)(iv)).

98. *See id.* at 64191 (to be codified at 17 C.F.R. § 230.139b(a)(2)(ii)(A), (a)(2)(ii)(B)).

99. *See id.*

100. *See id.* at 64192 (to be codified at 17 C.F.R. § 230.139b(a)(2)(ii)(A)).

101. *See id.* at 64192 (to be codified at 17 C.F.R. § 230.139b(a)(2)(iii)).

prominence in the publication than that given to any other covered investment fund issuer or its securities.[102]

If fund performance information is included in a research report, it must be presented in accordance with certain standardized presentation requirements depending on the type of investment fund covered.[103] For research reports that include registered open-end fund performance, the Commission requires that fund performance be presented according to the presentation and timeliness requirements of Rule 482 (closed-end funds may comply with the requirements of Form N-2 instead of Rule 482).[104]

A broker-dealer cannot include any covered investment fund that is an affiliate of the broker-dealer or for which the broker-dealer serves as an investment adviser in an industry research report.[105] Additionally, a broker-dealer may not selectively apply the Rule 139b safe harbor to certain aspects of an industry research report.[106] The safe harbor must apply to the entirety of the report.[107]

E. SEC Expands Regulation A Exemption to Exchange Act Reporting Companies

On December 19, 2018, the Commission amended Rule 251[108] and Rule 257[109] of the Securities Act, which are part of Regulation A,[110] in order to allow companies subject to the reporting requirements of section 13 or 15(d) of the Exchange Act[111] to make offerings in reliance on the Regulation A exemption. The rule changes were mandated by the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2017 (the "Economic Growth Act").[112]

Regulation A is an exemption from registration under the Securities Act for smaller public offerings.[113] It includes two overlapping tiers: Tier 1, for offerings of up to $20 million in a twelve-month period, and Tier 2, for offerings of up to

102. *See* 17 C.F.R. § 230.482(b)(3), (b)(5) (2019).

103. *See* Covered Fund Adopting Release, *supra* note 72, at 64193 (to be codified at 17 C.F.R. § 230.139b(a)(3)).

104. *See id.*; 17 C.F.R. § 230.482(d)–(e) (2019); *see also id.* § 239.14.

105. *See* Covered Fund Adopting Release, *supra* note 72, at 64191 (to be codified at 17 C.F.R. § 230.139b(a)(2)(ii)(B)); *see also* FAIR Act, Pub. L. No. 115-66, § 2(f)(3), 131 Stat. 1196, 1199 (2017).

106. *See* Covered Fund Adopting Release, *supra* note 72, at 64192 (to be codified at 17 C.F.R. § 230.139b(a)(2)(ii)(B)).

107. *See id.* Broker-dealers that are unable to rely on Rule 139b for the entirety of the research report may consider a Rule 482 communication that is styled as an industry report. *See generally* 17 C.F.R. § 230.482 (2019).

108. *See generally* Conditional Small Issues Exemption Under the Securities Act of 1933 (Regulation A), Release No. 33-10591, 84 Fed. Reg. 520 (Dec. 19, 2018) (to be codified at 17 C.F.R. §§ 230.251 & 230.257) [hereinafter Regulation A Adopting Release]; 17 C.F.R. § 230.251 (2019).

109. *See* Regulation A Adopting Release, *supra* note 108; 17 C.F.R. § 230.257 (2019).

110. 17 C.F.R. § 230.251-263 (2019).

111. 15 U.S.C. §§ 13, 15d (2018).

112. *See generally* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

113. *See generally* 17 C.F.R. § 230.251 (2019).

$50 million in twelve-month period.[114] Prior to the Commission's amendments, reporting companies were not eligible to rely on Regulation A.[115]

The Commission added a new paragraph to Rule 257(b) in order to specify that for Tier 2 issuers the duty to file periodic reports under Rule 257 of Regulation A shall be deemed to have been satisfied if a public company, as of each Form 1-K and Form 1-SA due date, has filed all reports required to be filed under the Exchange Act during the twelve months preceding such due dates.[116] The amendments use a twelve-month lookback period consistent with the standard applied in Commission rules in other contexts, including for the determination of eligibility to use a registration statement on Form S-8[117] and for satisfaction of the "current public information" requirement of Rule 144.[118]

The requirement that an issuer be current in, rather than merely subject to, Exchange Act reporting, in order to meet its Rule 257(b) obligations, is expected to encourage more regular periodic disclosures following a reporting company's Regulation A offering.[119] However, if at the relevant Form 1-K or Form 1-SA due date the issuer is not current in meeting its Exchange Act reporting requirements, the issuer's Rule 257 reporting obligation will not be deemed to have been met, and at that time the issuer will be required to file Regulation A–related reports.[120]

In addition, the Commission deleted current Rule 257(d)(1), which provides for an automatic suspension of the duty to file reports under Rule 257 if and so long as the issuer is subject to the duty to file reports pursuant to section 13 or 15(d) of the Exchange Act.[121] The Commission also made minor amendments to Rule 251(b)(6)[122] and Rule 257(e)[123] to conform Regulation A to the requirements of the Economic Growth Act.

The Commission's adopting release also clarifies that for Canadian issuers that rely on Regulation A and file reports with the Commission under the multijurisdictional disclosure system (MJDS), the Rule 257 reporting obligations will

114. *See* 17 C.F.R. § 230.251(a)(1), (a)(2) (2019).

115. *See* Regulation A Adopting Release, *supra* note 108 at 521 (noting the deletion of 17 C.F.R. § 230.251(b)(2).).

116. *See* Regulation A Adopting Release, *supra* note 108, at 521 (to be codified at 17 C.F.R. § 230.257(b)).

117. *See* 17 C.F.R. § 239.16b(a) (2019); *see also* Regulation A Adopting Release, *supra* note 108, at 521.

118. *See* 17 C.F.R. § 230.144(c)(1) (2019); *see also* Regulation A Adopting Release, *supra* note 108, at 521.

119. *See* Regulation A Adopting Release, *supra* note 108, at 521.

120. *Id.* ("Under the amendments, such an issuer technically will be subject to both reporting regimes; however, as long as the issuer remains current in its Exchange Act periodic reporting, its Exchange Act reports will be deemed to satisfy its ongoing reporting obligations under amended Rule 257(b).").

121. *Id.*; *see also* 17 C.F.R. § 230.257(d)(1) (2019).

122. *See* Regulation A Adopting Release, *supra* note 108, at 522 (to be codified at 17 C.F.R. § 230.251(b)(6)).

123. *See* Regulation A Adopting Release, *supra* note 108, at 521–22 (to be codified at 17 C.F.R. § 230.257(e)) (clarifying the operation of the rule if a reporting company issuer that is relying on new Rule 257(b)(6) to deem its Rule 257 reporting obligation met then terminates or suspends its duty to file reports under the Exchange Act).

have been deemed satisfied to the extent such issuers are current in their applicable Exchange Act reporting obligations.[124]

The Commission did not make any change to the Regulation A financial statement requirements.[125]

Expected Use of Regulation A

Reporting companies that are newly eligible to rely on Regulation A may realize several benefits from this offering alternative.[126] For example, access to Regulation A may make it easier and less costly for reporting companies to raise capital in smaller offerings of up to $50 million in any twelve-month period.[127] Issuers may solicit indications of interest (i.e., "test-the-waters communications") from any investor before qualification of an offering statement, which may allow them to gauge investor interest prior to deciding whether to incur the full cost of the offering.[128] This is particularly relevant for reporting companies that do not qualify as emerging growth companies (EGCs).[129]

Additionally, reporting companies the securities of which are not listed on an exchange whose offerings fall within Tier 2 can now benefit from blue sky preemption, which can expedite certain offerings and enable offers of securities across states to a wide variety of investors.[130] Regulation A also contains a safe harbor from integration of Regulation A offerings with any other prior or subsequent offers or sales of securities registered under the Securities Act.[131] However, Regulation A does not permit at-the-market offerings, which limits its attractiveness for some reporting companies.[132]

In the Commission's adopting release, the Commission notes that it anticipates that Exchange Act–reporting companies the securities of which are not exchange-listed are likely to consider the Regulation A offering alternative.[133] Issuers that are not eligible to use a registration statement on Form S-3 also may consider reliance on Regulation A.[134] An issuer that is subject to the one-third limitation on primary issuances pursuant to a registration statement on Form S-3 also might consider a Regulation A Tier 2 offering.[135]

124. *See* Regulation A Adopting Release, *supra* note 108, at 522.
125. *Id.* at 522.
126. *Id.* at 524–25.
127. *Id.*
128. *Id.*
129. *Id.*
130. *Id.* at 524.
131. *See* 17 C.F.R. § 230.251(c) (2019); Regulation A Adopting Release, *supra* note 108, at 525.
132. *See* Regulation A Adopting Release, *supra* note 108, at 524.
133. *See id.* at 525.
134. *Id.* at 524.
135. An issuer with less than $75 million in public float is eligible to use Form S-3 for a primary offering in reliance on Instruction I.B.6, which permits it to sell no more than one-third of its public float within a twelve-month period. *See* 17 C.F.R. § 239.13 (2018); *SEC Form S-3*, U.S. Sec. & Exchange Commission, https://www.sec.gov/about/forms/forms-3.pdf (last modified Sept 24, 2014) (General Instruction I.B.6).

F. Final Inline XBRL Rule in Filing Tagged Data

On June 28, 2018, the SEC issued amendments[136] requiring operating companies and funds to use Inline eXtensible Business Reporting Language ("XBRL") in some of their Commission submissions. The Inline XBRL format embeds the XBRL data directly into the filing, thereby making disclosure documents both human-readable and machine-readable.[137] The amendments took effect on September 17, 2018, and allow a phased-in compliance period to mitigate further the potential burden of the initial transition to the Inline XBRL format.[138]

Operating companies that prepare their financial statements in accordance with U.S. GAAP or International Financial Reporting Standards (IFRS) are now required to use the Inline XBRL format in submitting their financial statements and any applicable financial statement schedules as exhibits to relevant Exchange Act reports and Securities Act registration statements.[139] Funds are also required to use the Inline XBRL format in submitting risk/return summary information as exhibits to registration statements and to prospectuses with risk/return summary information that varies from the registration statement.[140] Both operating companies and funds are no longer required to post XBRL data on their websites.[141] Upon the amendments' effectiveness, the SEC 2005 XBRL Voluntary Program's financial statement information was terminated,[142] and some technical conforming changes were implemented (such as changes to rules for hardship exemptions, current public information under Rule 144(c)(1) of the Securities Act, form eligibility, and Rule S-T).[143]

G. SEC Amends Mining Disclosure Requirements to Align with Current Global Practices

On October 31, 2018, the Commission issued a final rule to modernize the property disclosure requirements for mining registrants and to provide related guidance.[144] The Commission amended Item 102[145] of Regulation S-K[146] under the Securities Act and the Exchange Act as well as Industry Guide 7.[147] The amendments consolidate the Commission's mining property disclosure

136. *See* Inline XBRL Filing of Tagged Data, Release No. 33-10514, 83 Fed. Reg. 40846 (June 28, 2018) (to be codified at 17 C.F.R. pts. 229, 230, 232, 239, 249, 270 & 274) [hereinafter Inline XBRL Adopting Release].

137. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Inline XBRL for Tagged Data (June 28, 2018), https://www.sec.gov/news/press-release/2018-117.

138. *See* Inline XBRL Adopting Release, *supra* note 136, at 40846, 40857.

139. *Id.* at 40847.

140. *Id.* at 40848.

141. *Id.* at 40868.

142. *Id.* at 40860.

143. *Id.*

144. Modernization of Property Disclosures for Mining Registrants, Release No. 33-10570, 83 Fed. Reg. 66344 (Oct. 21, 2018) (to be codified at 17 C.F.R. pts. 229, 230, 239 & 249) [hereinafter Mining Adopting Release].

145. *See* 17 C.F.R. § 229.102 (2019).

146. *See generally id.* § 229.

147. *See id.* §§ 229.801(g), 229.802(g).

requirements by relocating them to the newly created Subpart 1300 of Regulation S-K, which became effective on February 25, 2019.[148] The amendments are intended to help investors make more informed decisions while aligning the Commission's mining disclosure requirements more closely with current global practices and standards largely set forth by the Committee for Reserves International Reporting Standards ("CRIRSCO").[149] Any registrant with mining operations "material"[150] to its financial condition or business must comply with the new rules beginning on January 1, 2021.[151]

There are a number of updates to the mining disclosure requirements.[152] First, in addition to the disclosure of mineral reserves that has been required, registrants with material mining operations must now also disclose mineral resources.[153] In the past, Item 102 and Industry Guide 7 have deviated from foreign disclosure standards and only required the disclosure of mineral resources in limited circumstances.[154] This change was adopted in order to help provide clarity and to provide more complete information for the registrant's investors.[155]

The new rules require the disclosure of exploration results for the registrant's most recently completed fiscal year if such results are material to investors.[156] The determination of the "material" status of the exploration should be made by considering the relevant facts and circumstances.[157] Such relevant facts and circumstances include the significance of the exploration results when making a decision on whether to develop the property or in a valuation of the property and the stage of the particular property under consideration.[158]

Further, the new rules require any disclosure of mineral reserves, mineral resources or exploration results to be based on information prepared by a "qualified person."[159] To be deemed a "qualified person," an individual must (i) have good standing in an industry-recognized professional organization at the time the supporting documentation is being prepared and (ii) must have at least five years of experience in dealing with the specific type of mineralization under evaluation and

148. *See* Mining Adopting Release, *supra* note 144, at 66344 (to be codified at 17 C.F.R. §§ 229.1300–.1305).

149. *See* Mining Adopting Release, *supra* note 144, at 66344, 66345 n.18.

150. *Id.* at 66349 ("[F]or purposes of subpart 1300, the term material has the same meaning as under Securities Act Rule 405 or Exchange Act Rule 12b-2."); *see also* 17 C.F.R. § 229.1300 (2019).

151. *See* Mining Adopting Release, *supra* note 144, at 66344.

152. *Id. See* 17 C.F.R. § 229.1300 (2018).

153. The Mining Adopting Release provides the definition of "mineral resource" to be included in the new subpart 1300 ("a concentration or occurrence of material of economic interest in or on the Earth's crust in such form, grade or quality, and quantity that there are reasonable prospects for economic extraction"). Mining Adopting Release, *supra* note 144, at 66345–46 (to be codified at 17 C.F.R. § 229.1300); *see also* 17 C.F.R. § 229.1300 (2019).

154. *See* Mining Adopting Release, *supra* note 144, at 66370.

155. *Id.*

156. *Id.* at 66368 (to be codified at 17 C.F.R. § 229.1304(g)(1)–(2)).

157. *See* Mining Adopting Release, *supra* note 144, at 66368 (to be codified at 17 C.F.R. § 229.1304(g)(1)–(2)).

158. Mining Adopting Release, *supra* note 144, at 66368 (to be codified at 17 C.F.R. § 229.1304(g)(1)–(2)).

159. Mining Adopting Release, *supra* note 144, at 66359 (to be codified at 17 C.F.R. § 229.1302(a)(1)).

in the particular activity the individual is performing for the registrant.[160] This change helps to minimize the differences between those requirements previously set forth in Item 102 and Industry Guide 7, and those established by CRIRSCO.[161]

Finally, for each material property, a mining registrant must file a technical report summary prepared, dated, and signed by one or more qualified persons.[162] This report should contain information summarized by such qualified person relating to the mineral resources or mineral reserves on the material property in consideration.[163] The content requirements of the technical report summary were modeled on existing foreign standards[164] and were set forth to ensure that the necessary technical and scientific information could be provided for investment-decision purposes.[165] While not required, mining registrants may file a technical report summary to provide information about material exploration results.[166] A mining registrant must file a technical report summary as an exhibit to a Commission filing when disclosing any material change in mineral resources or material reserves on the property under consideration, or when disclosing mineral resources or material reserves for the first time on the property under consideration.[167] Provided it is comprised of mining experts, a third-party firm may sign and date the technical report summary without disclosing the name of the particular employee who prepared the technical report summary.[168]

The changes to the Commission's current mining disclosure requirements consolidate the disclosure requirements by rescinding Industry Guide 7 and relocating the requirements to the newly formed Subpart 1300 of Regulation S-K.

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160. Mining Adopting Release, *supra* note 144, at 66363–64 (to be codified at 17 C.F.R. § 229.1300).

161. *Id.* at 66365.

162. *Id.* at 66411 (to be codified at 17 C.F.R. § 229.1300); 17 C.F.R. § 229.601(b)(96)(i) (2019).

163. Mining Adopting Release, *supra* note 144, at 66411 (to be codified at 17 C.F.R. § 229.1300); 17 C.F.R. § 229.601(b)(96)(i) (2019).

164. The requirements are largely modeled on Canada's NI 43-101, CRIRSCO Table 1, and JORC Table 1. *See* Mining Adopting Release, *supra* note 144, at 66411.

165. *Id.*

166. Mining Adopting Release, *supra* note 144, at 66412 (to be codified at 17 C.F.R. § 229.1300); 17 C.F.R. § 229.601(b)(96)(i) (2019).

167. Mining Adopting Release, *supra* note 144, at 66443 (to be codified at 17 C.F.R. § 229.1300).

168. Mining Adopting Release, *supra* note 144, at 66347 (to be codified at 17 C.F.R. § 229.1300).

Accounting Developments 2018

In 2018, the Financial Accounting Standards Board (the "FASB") issued twenty Accounting Standards Updates ("ASUs") to its Accounting Standards Codification ("ASC" or the "Codification"), compared to fifteen ASUs in 2017. Of the twenty 2018 ASUs, the FASB issued six ASUs to simplify, clarify, or make targeted improvements to standards that were not yet effective for all entities. Four[1] of these six ASUs relate to the recognition of, and disclosure about, leasing transactions pursuant to a standard that the FASB adopted in 2016,[2] which is codified in ASC Topic 842, Leases ("ASC 842"); one[3] relates to the recognition of financial instruments and equity investments pursuant to a standard that the FASB adopted in 2016,[4] which is codified in ASC Topic 825, Financial Instruments ("ASC 825") and ASC Topic 321, Investments—Equity Securities ("ASC 321"), and one[5] relates to the recognition of the measurement of credit losses pursuant to a standard that the FASB adopted in 2016,[6] which is codified in ASC Topic 326, Financial Instruments—Credit Losses ("ASC 326"). Two[7] of the twenty 2018 ASUs were issued in connection with the FASB's standing projects on their agenda to simplify or improve current guidance, the so-called "Simplification" and "Improvements" projects.[8] Three of the 2018 ASUs make targeted improvements in the areas of long-duration contracts issued by insurance entities, variable interests, and collaborative arrangements;[9] two

1. See the discussions in *infra* sections A.1, 10, 11 & 19.

2. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-02, Leases (Topic 842) (Feb. 2016) [hereinafter ASU 2016-02].

3. See the discussion in *infra* section A.3.

4. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (Jan. 2016) [hereinafter ASU 2016-01].

5. See the discussion in *infra* section A.18.

6. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (June 2016) [hereinafter ASU 2016-13].

7. See the discussions in *infra* section A.7, related to share-based payment transactions with nonemployees, and *infra* section A.9.

8. The FASB has stated that the objective of the Simplification Initiative is "to identify, evaluate, and improve areas of [generally accepted accounting principles ('GAAP')] for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements." Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-07, Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting 170 (June 2018) [hereinafter ASU 2018-07]. The FASB's Improvements Project is intended "to clarify the Codification or correct unintended application of guidance that is not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities." Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-09, Codification Improvements 1 (July 2018) [hereinafter ASU 2018-09].

9. See the discussions in *infra* sections A.12, 16 & 17.

provide guidance as a result of the 2017 Tax Cuts and Jobs Act, enacted on December 22, 2017 (the "2017 Tax Act");[10] two delete regulatory guidance that the staff (the "SEC Staff") of the U.S. Securities and Exchange Commission ("SEC") and the Office of the Comptroller of the Currency rescinded;[11] and two adopt disclosure requirements related to fair value measurement and defined benefit plans as a part of the FASB disclosure framework project.[12] One ASU addresses diversity in practice relating to the accounting for contributions received by, and made to, not-for-profit entities,[13] and one addresses hedge accounting as a result of concerns about the sustainability of the London Interbank Offered Rate ("LIBOR") sweep rate.[14] The FASB issued one ASU that articulates a consensus of the FASB's Emerging Issues Task Force (the "EITF")[15] and did not issue any ASUs that articulates a consensus of the FASB's Private Company Council (the "PCC"). In 2017, the FASB issued fifteen ASUs, including five that simplify or make targeted improvements to standards, three ASUs that clarify standards, including the revenue recognition standard adopted in 2014,[16] which is codified in ASC Topic 606, Revenue from Contracts with Customers ("ASC 606"), three ASUs that reflect the views of the SEC Staff, two ASUs that articulate consensuses of the EITF, one ASU that eliminates obsolete guidance, and one ASU related to not-for-profit entities.

The EITF, which was formed in 1984, seeks to address emerging accounting issues before divergent approaches to those issues become widespread.[17] The FASB must approve all consensuses reached by the EITF.[18] The EITF is chaired by the FASB's technical director, has members from the auditing profession and from the preparer and financial statement user communities, and observers from the FASB, the SEC, the Financial Reporting Executive Committee of the American Institute of Certified Accountants (the "AICPA"), and the International Accounting Standards Board.[19]

The PCC was formed by the Board of Trustees of the Financial Accounting Foundation (the "FAF") in May 2012 to determine whether exceptions or modifications to United States generally accepted accounting principles ("GAAP"), including ASUs being considered by the FASB, are appropriate to address the needs of users of private company financial statements.[20] The FASB must

10. See the discussions in *infra* sections A.2 & 5.

11. See the discussions in *infra* sections A.4 & 6.

12. See the discussions in *infra* sections A.13 & 14.

13. See the discussion in *infra* section A.8.

14. See the discussion in *infra* section A.15.

15. See the discussion in *infra* section B.1.

16. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) (May 2014) [hereinafter ASU 2014-09].

17. *Emerging Issues Task Force (EITF), About the EITF*, Fin. Acct. Standards Board, https://www.fasb.org/eitf/about_eitf.shtml (last visited Jan. 9, 2019).

18. *Id.*

19. *Id.*

20. Fin. Accounting Found. Bd. of Trs., Establishment of the Private Council: Final Report 2 (May 30, 2012), http://www.accountingfoundation.org/cs/ContentServer?c=Document_C&cid=1176160066778&d=&pagename=Foundation%2FDocument_C%2FFAFDocumentPage.

endorse all consensuses reached by the PCC.[21] Similar to the EITF, the members of the PCC are from the auditing profession and from the preparer and financial statement user communities with significant experience conducting audits or preparing or using private company financial statements.[22] An FASB member is a liaison between the PCC and FASB, and the FASB provides technical and administrative staff to work with the PCC.

The following is a discussion about (a) the ASUs that the FASB issued in 2018 that were not originated by the EITF or the PCC and (b) the ASU that was originated by the EITF in 2018.

A. ASUs Originated by the FASB

1. Practical Expedient in Lease Accounting Implementation for Land Easements

In January 2018, the FASB issued ASU No. 2018-01,[23] which addresses stakeholder concerns about the costs and complexity of complying with the transition provisions of the new lease requirements in ASC 842 as they relate to land easements that are not now accounted for as leases.[24] Under current lease accounting requirements, land easements are not treated as leases on a consistent basis.[25] ASU 2018-01 provides a practical expedient that permits stakeholders to exclude existing or expired land easements that have not been accounted for as leases under the prior applicable standards for leases from evaluation under ASC 842.[26] Land easements represent the right to use, access, or cross another entity's land for a specified purpose and are also referred to as rights of way.[27] Entities that do not now treat land easements as leases advised the FASB that evaluating all existing or expired land easements in connection with the adoption of the new lease standard would be costly and complex.[28] ASU 2018-01 states that an entity that relies on the practical expedient must apply the same accounting policy to such existing or expired land easements as it used prior to adoption of ASC 2016-02[29] and must evaluate new or modified land easements under ASC 842 beginning on the date that it adopts ASC 2016-02.[30] An entity that does not rely on the practical expedient should evaluate all existing or expired land easements to determine whether they meet the definition of a lease as it implements the new lease requirements in ASC 842.[31]

21. *Id.*
22. *Id.*
23. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-01, Leases (Topic 842) (Jan. 2018) [hereinafter ASU 2018-01].
24. *Id.* at 1.
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.* at 2.
30. *Id.* at 1.
31. *Id.*

ASU 2018-01 is effective at the same time as the new lease accounting provisions in ASC 842.[32] That means that financial statements of public business entities,[33] certain not-for-profit entities, and employee benefit plans that file financial statements with the SEC must comply with ASU 2018-01 for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.[34] Other entities must comply with ASU 2018-01 in financial statements for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.[35] Early application of the new lease accounting provisions is permitted for all entities. Entities are not permitted to change their accounting treatment for land easements before adopting ASU 2016-02 unless they comply with ASC Topic 250, Accounting Changes and Error Corrections, including the requirement that the change should be preferable.[36]

32. *Id.* at 2.

33. Each of the following entities is a "public business entity," as defined by the FASB:

> a. An entity that files financial statements with or furnishes financial statements to the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
>
> b. An entity that files financial statements with or furnishes financial statements to a regulatory agency other than the SEC pursuant to the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act.
>
> c. An entity that files financial statements with or furnishes financial statements to a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
>
> d. An entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
>
> e. An entity that has one or more securities that are not subject to contractual restrictions on transfer, and is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

Master Glossary, Accounting Standards Codification, FIN. ACCT. STANDARDS BOARD, https://asc.fasb.org/glossary&letter=P (last visited Jan. 9, 2019) (password protected).

As noted in *Accounting Developments 2017*, the SEC Staff announced at a meeting of the EITF on July 20, 2017, that it would not object if an entity that meets the FASB's definition of public business entity solely because its financial statements or financial information must be included in another entity's SEC filings complies with ASC 842 as well as ASC 606 relating to revenue recognition at the effective dates applicable to entities that do not meet the FASB's definition of public business entity. 73 BUS. LAW. 849, 869 (2017) (describing the FASB's ASU that added the SEC's guidance to the Codification, Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-13, Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments (Sept. 2017)).

34. ASU 2016-02, *supra* note 2, at 7.

35. *Id.*

36. ASU 2018-01, *supra* note 23, at 11.

2. Relief for Treatment of Stranded Tax Effects Resulting from Tax Reform

In February 2018, the FASB issued ASU No. 2018-02,[37] which addresses stakeholders' concerns about the accounting implications of the 2017 Tax Act.[38] Stakeholders in the banking and insurance industries had asserted that investors may be confused because the accounting guidance related to income taxes, ASC Topic 740, Income Taxes ("ASC 740"), requires an entity to reflect any adjustment in deferred tax liabilities and assets for the effect of a change in tax laws or rates in income from continuing operations in the reporting period that includes the enactment date even if the related income tax effects of items in accumulated other comprehensive income were originally charged or credited directly to other comprehensive income or to related components of shareholders' equity in accordance with applicable income tax accounting requirements.[39] Accordingly, the adjustment of deferred taxes as a result of the reduction of the historical corporate income tax rate is reflected in income from continuing operations but the tax effects of items within accumulated other comprehensive income, referred to as stranded tax effects in ASU 2018-02, do not reflect the appropriate tax rate.[40] In addition, some banks had asserted that recording the tax effects of the adjustment of deferred taxes in income from continuing operations might adversely affect regulatory capital.[41]

ASU 2018-02 permits entities to reclassify the stranded tax effects resulting from the 2017 Tax Act on items within accumulated other comprehensive income to retained earnings.[42] In addition, ASU 2018-02 requires certain disclosures about stranded tax effects whether or not the entity elects to reclassify the income tax effects of the 2017 Tax Act.[43]

ASU 2018-02 is effective for financial statements of all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.[44] Early adoption of the amendments is permitted, including in any interim period, by public business entities for reporting periods for which financial statements have not yet been issued and by other entities for reporting periods for which financial statements have not yet been made available for issuance.[45] The amendments should be applied either in the period of adoption or retrospectively to each period that reflects the change in the U.S. federal corporate income tax rate in the 2017 Tax Act.[46]

37. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-02, Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (Feb. 2018) [hereinafter ASU 2018-02].
38. *Id.* at 8.
39. *Id.*
40. *Id.* at 1.
41. *Id.* at 8.
42. *Id.* at 1.
43. *Id.* at 2, 4.
44. *Id.* at 2.
45. *Id.*
46. *Id.*

In addition to ASU 2018-02, the FASB staff has issued five documents, which it calls "Staff Q&A documents," which address various financial accounting and reporting implementation questions related to the 2017 Tax Act.[47] These Q&A documents address the following topics:

- The use of SEC Staff guidance by private companies and not-for-profit entities.[48]
- The recognition of the tax liability on the deemed repatriation of earnings on a non-discounted basis.[49]
- The recognition of a corporate alternative minimum tax credit carryforward on a non-discounted basis.[50]
- The treatment of the base erosion anti-abuse tax.[51]
- The treatment of global intangible low-taxed income.[52]

3. Technical Corrections and Improvements to the Accounting for Financial Instruments

In February 2018, the FASB issued ASU No. 2018-03,[53] which clarifies various aspects of the accounting guidance for financial instruments adopted in ASU No. 2016-01.[54] ASU 2016-01 made targeted improvements to ASC Topic 825-10, Financial Instruments—Overall ("ASC 825-10"), in the areas of recognition, measurement, presentation, and disclosure of financial instruments and added a new topic to the Codification, ASC 321, Investments—Equity Securities.[55]

ASU 2018-03 addresses six issues relating to the accounting for financial instruments in accordance with ASC Topics 321 and 825 that stakeholders had

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47. *See Accounting for the Tax Cuts and Jobs Act—How Is the FASB Addressing Related Implementation Issues?*, Fin. Acct. Standards Board, https://www.fasb.org/jsp/FASB/Page/BridgePage&cid=1176169774397#section_3 (last visited Jan. 9, 2019).

48. *FASB Staff Q&A, Topic 740, No. 1*, Fin. Acct. Standards Board, https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176169777449&d=&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay (last visited Jan. 9, 2019).

49. *FASB Staff Q&A, Topic 740, No. 2*, Fin. Acct. Standards Board, https://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176169882916&d=&pagename=FASB%2FDocument_C%2FDocumentPage (last visited Jan. 9, 2019).

50. *FASB Staff Q&A, Topic 740, No. 3*, Fin. Acct. Standards Board, https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176169881426&d=&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay (last visited Jan. 9, 2019).

51. *FASB Staff Q&A, Topic 740, No. 4*, Fin. Acct. Standards Board, https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176169881716&d=&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay (last visited Jan. 9, 2019).

52. *FASB Staff Q&A, Topic 740, No. 5*, Fin. Acct. Standards Board, https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176169882008&d=&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay (last visited Jan. 9, 2019).

53. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-03, Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (Feb. 2018) [hereinafter ASU 2018-03].

54. *Id.* at 1.

55. *Id.*

brought to the attention of the FASB.[56] Below, we summarize these issues and the relevant amendments:

1. Equity Securities Without a Readily Determinable Fair Value:

   a. Criteria for discontinuation of the use of the measurement alternative in Subtopic 35-1 of ASC 321-10, Investments—Equity ("ASC 321-10"): The amendments provide that, in addition to the discontinuation of the alternative when an investment has a readily determinable fair value or becomes eligible for the net asset value practical expedient, an entity may make an irrevocable election to use the fair value method in accordance with ASC Topic 820, Fair Value Measurement ("ASC 820"), provided it uses that method for all identical or similar investments of the same issuer.[57]

   b. Date as of which an adjustment should be made to reflect the fair value of a security in an observable transaction: When ASC 321-10-55-09 requires an adjustment in the fair value of a security because of an observable transaction, the date as of which the fair value is adjusted should be the date on which the observable transaction took place.[58]

   c. Use of the prospective transition approach for equity securities without a readily determinable fair value when the measurement alternative is not applied upon transition: The prospective transition approach for equity securities without a readily determinable fair value is only applicable when the measurement alternative is applied.[59] In addition, an insurance entity subject to the guidance in ASC Topic 944, Financial Services—Insurance ("ASC 944"), should use a prospective transition approach for equity securities without readily determinable fair values and that approach should be applied consistently to the entity's entire population of equity securities for which the measurement alternative is elected.[60]

2. Forward Contracts and Purchased Options: Need for remeasurement of the entire value of the forward contract or purchased option when there is a change in observable price or impairment of the equity investment underlying a forward contract or purchased option: The entire value of a forward contract or purchased option must be remeasured when observable transactions occur on the underlying equity securities.[61]

56. *Id.* at 2–4.
57. *Id.* at 2.
58. *Id.*
59. *Id.* at 3.
60. *Id.* at 3–4.
61. *Id.* at 2.

3. Fair Value Option Liabilities:

   a. The applicability of the presentation requirements in ASC 825-10-45-5 to certain hybrid financial liabilities for which the fair value option has been elected: The presentation requirements in ASC 825-10-45-5 apply whenever the fair value option is elected for a financial liability.[62]

   b. Measurement of a fair value change attributable to instrument-specific credit risk for a foreign-currency-denominated liability for which the fair value option is elected: The amount of the change in fair value that relates to the instrument-specific credit risk should first be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability and then both components of the change in the fair value of the liability should be remeasured into the functional currency of the reporting entity using end-of-period spot rates.[63]

ASU 2018-03 is effective for financial statements of public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018; however, public business entities with fiscal years beginning between December 15, 2017, and June 15, 2018, are not required to adopt the amendments until the interim period beginning after June 15, 2018.[64] Public business entities with fiscal years beginning between June 15, 2018, and December 15, 2018, and all other entities are not required to adopt these amendments before adopting the amendments in ASU 2016-01.[65] ASU 2016-01 is effective for pubic business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, and for other entities for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.[66] Any entity that adopts ASU 2016-01 early, in accordance with the limited permitted circumstances,[67] may also adopt early the amendments in ASU 2018-03.[68]

4. Deletion of Superseded Guidance Related to Impaired Equity Investments

In March 2018, the FASB issued ASU No. 2018-04[69] to remove certain SEC guidance in the Codification related to the accounting for equity securities and

62. *Id.* at 2–3.
63. *Id.* at 3.
64. *Id.* at 4.
65. *Id.*
66. ASU 2016-01, *supra* note 4, at 4.
67. *Id.*
68. ASU 2018-03, *supra* note 53, at 4.
69. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-04, Investments—Debt Securities (Topic 320) and Regulated Operations (Topic 980): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 117 and SEC Release No. 33-9273 (Mar. 2018) [hereinafter ASU 2018-04].

public utility holding companies. ASU 2018-4 eliminates various paragraphs of ASC Subtopic 320-10 related to the impairment of individual available-for-sale and held-to-maturity securities[70] as a result of the issuance by the SEC Staff of SEC Staff Accounting Bulletin No. 117.[71] The SEC Staff issued SAB 117 to eliminate its guidance in Topic 5.M in the SEC Staff Accounting Bulletin Series in light of the FASB's adoption in ASU 2016-01 of ASC 321, which eliminates an entity's ability to present changes in the fair value of investments in equity securities within other comprehensive income.[72] The adoption of ASC 321, which, as noted above, is effective for public business entities for fiscal years beginning after December 15, 2017,[73] eliminates the need for the SEC Staff's guidance in Topic 5.M in the SEC Staff Accounting Bulletin Series related to the evaluation of whether an impairment loss should be recognized in net income for investments in equity securities that were measured at fair value with changes in fair value presented in other comprehensive income.[74]

In addition, ASU 2018-04 amends various paragraphs of ASC Topic 810, Consolidation ("ASC 810"), to note that the paragraphs are superseded as a result of revisions to Regulation S-X[75] that the SEC announced in Securities Act Release No. 9273, which the FASB identifies as SEC Release No. 33-9273.[76] These Regulation S-X revisions reflected, among other things, the repeal of the Public Utility Holding Company Act in 2006.[77]

5. Addition of SEC Staff Guidance Related to Tax Reform

In March 2018, the FASB issued ASU No. 2018-05[78] to add to the Codification the SEC Staff's guidance related to the income tax implications of the 2017 Tax Act set forth in SEC Staff Accounting Bulletin No. 118.[79] The SEC Staff issued SAB 118 to express its views regarding application of ASC Topic 740 in the reporting period that includes the date on which the 2017 Tax Act was signed into law, December 22, 2017.[80] ASU 2018-05 adds various paragraphs to ASC Subtopic 740-10 to reference and set forth in full the SEC Staff's guidance in SAB 118.[81]

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70. *Id.* at 1–3.
71. Staff Accounting Bulletin No. 117 (Nov. 29, 2017), https://www.sec.gov/interps/account/staff-accounting-bulletin-117.htm [hereinafter SAB 117].
72. *Id.*
73. *See* text accompanying *supra* note 53.
74. SAB 117, *supra* note 71.
75. ASU 2018-04, *supra* note 69, at 3–4.
76. Rescission of Outdated Rules and Forms, and Amendments to Correct References, Securities Act Release No. 9273 (Nov. 4, 2011), https://www.sec.gov/rules/final/2011/33-9273.pdf.
77. *Id.*
78. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-05, Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118 (Mar. 2018) [hereinafter ASU 2018-05].
79. Staff Accounting Bulletin No. 118 (Dec. 22, 2017), https://www.sec.gov/interps/account/staff-accounting-bulletin-118.htm [hereinafter SAB 118].
80. *Id.*
81. ASU 2018-05, *supra* note 78, at 3–8.

ASC Subtopic 740-10-S99-2A sets forth the text of SAB 118.[82] SAB 118 notes that the 2017 Tax Act includes various provisions that impact businesses, including through changes in corporate tax rates, business-related exclusions, and deductions and credits, and provisions that will affect companies that have international operations.[83] Based on feedback from registrants, the SEC Staff determined to issue SAB 118 because it became aware that registrants may be unable to complete the accounting for all of the tax effects of the Tax Act by the time their financial statements are issued for the period ended December 31, 2017, as required by ASC Topic 740.[84] SAB 118 addresses the uncertainty or diversity of views in practice regarding the application of ASC Topic 740 in circumstances where a registrant does not have the necessary information available, prepared, or analyzed in reasonable detail to complete the accounting required by ASC Topic 740 for the tax effects of the Tax Act in the period ended December 31, 2017.[85]

In brief, SAB 118 provides that the SEC Staff expects registrants to exercise good faith to complete the required accounting under ASC Topic 740 but provides relief for up to one year from the enactment date of the Tax Act when the accounting for certain of the tax effects is not complete.[86] Similar to the limited guidance that the FASB issued to address the income tax accounting effects of the American Jobs Creation Act of 2004 and the accounting requirements applicable to business combinations with respect to which the accounting may be finalized over time, SAB 118 notes that reasonable estimates of income tax effects for which the accounting is not complete, which should be reported as provisional amounts, should be included in financial statements for the period ended December 31, 2017, or for the first period thereafter when the registrant is able to determine a reasonable estimate.[87]

6. Elimination of Outdated Bank Regulatory Guidance

In May 2018, the FASB issued ASU No. 2018-06[88] to supersede outdated guidance issued by the Office of the Comptroller of the Currency in Banking Circular 202, Accounting for Net Deferred Tax Charges (Circular 202).[89] Since the Office of the Currency rescinded the guidance in Circular 202, the FASB's guidance in ASC Subtopic 942-740, Financial Services—Depository and Lending—Income Taxes, is no longer relevant.[90] The amendments in ASU 2018-06 were effective upon issuance of the ASU.[91]

82. *Id.*
83. SAB 118, *supra* note 79.
84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.*
88. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-06, Codification Improvements to Topic 942, Financial Services—Depository and Lending (May 2018) [hereinafter ASU 2018-06].
89. *Id.* at 1.
90. *Id.*
91. *Id.* at 2.

7. Share-Based Payment Transactions with Nonemployees

In June 2018, the FASB issued ASU No. 2018-07,[92] which is intended to simplify the accounting for nonemployee share-based payment transactions.[93] The FASB issued this update as a part of its initiative to reduce cost and complexity in accounting standards (Simplification Initiative).[94] The changes in this update are broader than those made in connection with other Simplification Initiative projects because this update changes the accounting requirements for share-based payment awards to nonemployees in a substantive way by more closely aligning the requirements with economically similar share-based payment transactions with employees.[95] Despite the significance of the changes adopted in ASU 2018-07, the FASB believes that the revised requirements will reduce future costs by eliminating an entity's need for a separate process for granting and tracking awards to nonemployees that are economically similar to those granted to employees.[96]

ASU 2018-07 expands ASC Topic 718, Compensation—Stock Compensation ("ASC 718"), to include all share-based payment transactions for acquiring goods and services from nonemployees and supersedes ASC Subtopic 505-50, Equity—Equity-Based Payments to Non-Employees.[97] The amendments to ASC 718 provide that ASC 718 applies to all share-based payment transactions an entity issues in consideration for its acquisition of goods or services to be used or consumed in its own operations.[98] Share-based payments to nonemployees that will not be subject to the provisions of ASC 718 are share-based payments (1) used to provide financing to the grantor or (2) issued in conjunction with the sale of goods or services to customers as part of a contract accounted for under ASC 606, Revenue from Contracts with Customers.[99]

ASU 2018-07 improves the following areas of nonemployee share-based payment accounting within its scope:

- Overall Measurement Objective: As a result of ASU 2018-07, rather than measuring nonemployee share-based payment awards at the fair value of the consideration received or the fair value of the equity instruments issued, whichever can be more reliably measured, the nonemployee share-based payment awards will be measured at the grant-date fair value of the equity instrument that the grantor is required to issue once the good has been delivered or the service has been rendered and any other applicable conditions are satisfied.[100]

92. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-07, Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting (June 2018) [hereinafter ASU 2018-07].
93. *Id.* at 1.
94. *Id.* at 170.
95. *Id.*
96. *Id.* at 171.
97. *Id.* at 172.
98. *Id.* at 1.
99. *Id.*
100. *Id.* at 2.

- Measurement Date: As a result of ASU 2018-07, rather than a measurement date of the earlier of the date at which a commitment for performance is reached and the date at which the performance is complete, the measurement date for the nonemployee share-based payment award will be the grant date, that is, the date at which the grantor and the grantee reach a mutual understanding of the key terms and conditions of the share-based payment award.[101]
- Awards with Performance Conditions: As a result of ASU 2018-07, rather than measuring a nonemployee share-based payment award at the lowest aggregate fair value, a nonemployee share-based payment award with a performance condition will be measured based on the probability that the performance condition will be satisfied.[102]
- Classification Reassessment of Certain Equity-Classified Awards: As a result of ASU 2018-07, the classification of an equity-classified nonemployee share-based payment award will no longer need to be reassessed upon vesting of the award as long as the award is not modified after the good has been delivered or the service has been rendered and any other conditions necessary to the vesting of the award have been satisfied.[103]

ASU 2018-07 also includes the following non-public entity specific amendments:

- Calculated Value: Unlike current GAAP, ASU 2018-07 provides that historical volatility of an appropriate industry sector should be used by non-public entities for expected volatilities as inputs to the valuation of share options and similar instruments issued to nonemployees when it is not practicable for the non-public entity to estimate the expected volatility of its share price.[104]
- Intrinsic Value: Unlike current GAAP, which requires that entities measure liability-classified nonemployee share-based payment awards at fair value, ASU 2018-07 provides that a nonpublic entity may make a one-time election to switch from measuring a liability-classified nonemployee share-based payment award at fair value to intrinsic value. In addition, ASU 2018-07 provides that liability-classified awards are subject to remeasurement until exercise.[105]

ASU 2018-07 is effective for financial statements of public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, and financial statements of other entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after

101. *Id.*
102. *Id.*
103. *Id.* at 3.
104. *Id.*
105. *Id.*

December 15, 2020.[106] Early adoption is permitted, as long as the entity has already adopted ASC 606.[107] An entity should adopt the new guidance on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.[108] An entity should only remeasure liability-classified awards that have not been settled by the date of adoption and equity-classified awards for which a measurement date has not been established.[109] Upon transition, an entity is required to measure these nonemployee awards at fair value as of the adoption date.[110] An entity must not remeasure assets that are completed, such as finished goods inventory or equipment with respect to which the entity has begun to recognize amortization.[111] A non-public entity must apply the guidance on calculated value prospectively to all awards that are measured at fair value after the effective date.[112] Upon adoption of the standard, an entity must disclose the nature of and reason for the change in accounting principle, and, if applicable, quantitative information about the cumulative effect of the change on retained earnings or other components of equity.[113]

8. Contributions Received by and Contributions Made to Not-for-Profit Entities

In June 2018, the FASB issued ASU No. 2018-08,[114] which is intended to clarify and improve the accounting guidance for contributions received and contributions made by not-for-profit entities as well as any other entities, including business entities, that receive or make contributions of cash and other assets.[115] Stakeholders had reported to the FASB the diversity in practice resulting from the difficulties in the characterization of grants and similar contracts with resource providers as either exchange transactions or contributions.[116] These difficulties became more pronounced as a result of the newly effective revenue recognition guidance in ASC 606, which applies to exchange transactions, whereas contributions are subject to ASC Subtopic 958-605, Not-for-Profit Entities—Revenue Recognition.[117] Stakeholders had also reported difficulties in determining whether a contribution is conditional, particularly when the contribution is accompanied with stipulations but no requirement for a return when the stipulations are not met, and diversity in the assessment of the likelihood of meeting a

106. *Id.* at 4.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.* at 180.
113. *Id.* at 4.
114. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-08, Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made (June 2018) [hereinafter ASU 2018-08].
115. *Id.* at 1–2.
116. *Id.* at 1.
117. *Id.*

condition that is remote, which affects the timing of revenue recognition.[118] The FASB expects that ASU 2018-08 will likely result in more grants and contracts being accounted for as either contributions or conditional contributions.[119]

The amendments enhance the existing framework for evaluating whether a transaction should be accounted for as a contribution or an exchange transaction and whether a contribution should be regarded as conditional.[120] With respect to the determination whether a transfer of assets is an exchange transaction in which the resource provider receives commensurate value, the amendments clarify that a resource provider is not receiving commensurate value in exchange for its transfer of assets, or the reduction, settlement, or cancellation of liabilities (referred to jointly as the "resource provider's activity"), simply because the public as a whole benefits from the resource provider's activity or when the resource provider's activity is consistent with its mission or results in positive sentiment from acting as a donor.[121] Even if a resource provider is not receiving commensurate value in exchange for the resource provider's activity, other GAAP, like ASC 606, will apply if the resource provider's activity is on behalf of an existing exchange transaction between the recipient and an identified customer.[122]

With respect to the determination whether a contribution is conditional, the amendments require an entity to determine whether the contribution includes a barrier that must be overcome and whether the agreement, or another document referenced in the agreement, provides a right of return of assets transferred or a right of release of a promisor's obligation to transfer assets.[123] The amendments set forth examples of indicators of a potential barrier, such as a requirement that the recipient achieve a designated goal prior to its use of the transferred assets.[124] In addition, they clarify that, once a contribution has been determined to be unconditional, an entity must determine whether the contribution includes other restrictions on its use, such as its availability only after a specified date.[125]

The effective date of ASU 2018-08 differs for contributions received by an entity and contributions made by an entity. With respect to contributions received by an entity, ASU 2018-08 is effective for financial statements of a public business entity (and a not-for-profit entity that has issued, or is a conduit bond obligator for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market and serves as a resource recipient) for fiscal years beginning after June 15, 2018, and interim periods within those fiscal years, and financial statements of other entities for fiscal years beginning after December 15, 2018,

118. *Id.* at 1–2.
119. *Id.* at 4.
120. *Id.*
121. *Id.* at 2.
122. *Id.* at 3.
123. *Id.* at 2–3.
124. *Id.* at 3.
125. *Id.*

and interim periods within fiscal years beginning after December 15, 2019.[126] With respect to contributions made by an entity, ASU 2018-08 is effective for financial statements of a public business entity (and a not-for-profit entity that has issued, or is a conduit bond obligator for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market and serves as a resource provider) for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, and financial statements of other entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.[127] Early adoption is permitted.[128]

The amendments must be adopted on a modified prospective basis, although retrospective application is permitted.[129] The modified prospective basis requires that an entity apply the amendments to the portion of revenue (of a recipient) or expense (of a resource provider) under a contract that has not been recognized before the effective date or entered into after the effective date.[130] Prior-period financial statements should not be restated and no cumulative-effect adjustment to the opening balance of net assets or retained earnings should be recognized at the beginning of the year of adoption.[131] The amendments require an entity to disclose the nature of and reason for the accounting change and explain any significant changes in each financial statement line item resulting from adoption of the new guidance.[132]

9. Minor Corrections, Clarifications, and Improvements to the Codification

In July 2018, the FASB issued ASU No. 2018-09,[133] which amends the Codification to make a wide variety of minor corrections, clarifications, and improvements that are intended to facilitate compliance with the accounting standards, including by eliminating inconsistencies.[134] The FASB adopted the amendments in connection with its standing project "to clarify the Codification or correct unintended application of guidance that is not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities,"[135] which is referenced herein as the "Improvements Project." The amendments include items that stakeholders had raised.[136]

The amendments relate to thirty topics, which include the following items that the FASB believes entities may have accounted for incorrectly or inconsistently[137]:

126. *Id.* at 5.
127. *Id.*
128. *Id.*
129. *Id.* at 4.
130. *Id.*
131. *Id.* at 5.
132. *Id.*
133. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-09, Codification Improvements (July 2018) [hereinafter ASU 2018-09].
134. *Id.* at 7.
135. *Id.* at 1.
136. *Id.*
137. *Id.* at 2.

(1) Taxes not payable in cash (Issue 1)[138]: The amendments to ASC 220-10, Income Statement—Reporting Comprehensive Income—Overall, include in ASC 220-10-45-10B a reference to tax benefits arising from certain quasi-reorganizations and remove the improper reference to "taxes not payable in cash" in the list of items that do not qualify for treatment as an item of comprehensive income because they are required to be reported as a direct adjustment to paid-in capital, retained earnings, or some other nonincome equity account.[139] The FASB explained that the phrase "taxes not payable in cash" could result in an unintended interpretation that any tax expense that is not payable in cash, including the utilization of a deferred tax asset, must be reported as a direct adjustment to paid-in capital.[140] In addition, the unintended interpretation would conflict with other guidance that generally states that income taxes and adjustments to those accounts upon a business combination or a bankruptcy that is eligible for fresh-start reporting must be recognized in income.[141]

(2) Extinguishment of Debt Accounted for at Fair Value (Issue 4)[142]: The amendments to ASC 470-50, Debt—Modifications and Extinguishments, clarify ASC 470-50-40-2A to provide that, upon an extinguishment of debt that has been accounted for at fair value pursuant to the election of the fair value option, the net carrying amount of the extinguished debt is equal to its fair value on the reacquisition debt for purposes of the requirement that income be recognized in the period of the extinguishment in the amount equal to the difference between the reacquisition price and the net carrying amount of the extinguished debt.[143]

(3) Freestanding Option Contracts with a Noncontrolling Interest (Issue 6)[144]: The amendments to ASC 480-10, Distinguishing Liabilities from Equity—Overall, conform the guidance in ASC 480-10-55-55 and ASC 480-10-55-50, which relate to freestanding option contracts, to the guidance in ASC 480-10-25-10, which prohibits the combination of freestanding financial instruments within the scope of ASC 480-10 with a noncontrolling interest unless the combination is required by ASC 815, Derivatives and Hedging.[145]

(4) Timing of the Recognition of Excess Tax Benefits (or Tax Deficiencies) Related to Share-Based Compensation (Issue 7)[146]: The amendments to ASC 718-740, Compensation—Stock Compensation—Income Taxes, clarify ASC 718-740-35-2 to provide that the tax effect of the difference between the cumulative compensation cost of an award recognized for financial reporting purposes and the deduction for an award for tax purposes, that is, an excess tax benefit or tax deficiency, must be recognized as income tax expense or benefit in the income statement in the same period in which the deduction is determined, which, typically, is when an award

138. *Id.* at 11.
139. *Id.* at 12.
140. *Id.* at 2.
141. *Id.*
142. *Id.* at 15.
143. *Id.* at 3.
144. *Id.* at 16.
145. *Id.* at 3.
146. *Id.* at 18.

is exercised or expires, in the case of options, or vests, in the case of nonvested stock awards.[147] This guidance applies even when the deduction is taken in an entity's tax return in a different period from the period in which the event that generates the deduction occurs and even when there is uncertainty about the receipt of the deduction or the amount of the tax deduction.[148]

(5) Allocation of Consolidated Tax Provision to an Acquired Entity (Issue 11)[149]: The amendment to ASC 805-740, Business Combination—Income Taxes, revises the guidance in ASC 805-740-25-13 related to the allocation of the consolidated tax provision to an acquired entity after acquisition to conform to the guidance in ASC 740, which was issued after the guidance in ASC 805-740-25-13, and requires the tax allocation to be systematic, rational, and consistent.[150]

(6) Circumstances for Offsetting Derivatives (Issue 12)[151]: The amendments to ASC 815-10, Derivatives and Hedging—Overall, supersede ASC 815-10-45-4 and revise ASC 815-10-45-5 to correct the potentially misleading suggestion in ASC 815-10-45-4 that derivatives may only be offset when all four of the conditions in ASC 210-20-45-1 are met.[152] The criterion that requires an intent to set off does not have to be met to offset derivative assets and liabilities for certain amounts arising from derivative instruments recognized at fair value and executed with the same counterparty under a master netting agreement.[153]

(7) Amendments to ASC 820-10, Fair Value Measurement—Overall ("ASC 820-10"): ASU 2018-09 adopts the following amendments to ASC 820-10: (1) amendments to ASC 820-10-35-16D (Issue 14)[154] that clarify that, when a third party that holds an asset is subject to a restriction on the transfer of the asset, the fair value of the underlying liability or equity instrument held by the issuer would include the effect of such transfer restriction on the asset;[155] (2) amendments to ASC 820-10-35-18D through 35-18F and ASC 820-10-35-18H through 35-18L (Issue 16)[156] that expand the availability of the "portfolio exception" to valuation to permit entities to measure fair value on a net basis for portfolios in which both financial assets and liabilities and nonfinancial instruments are managed and valued together;[157] and (3) amendments to ASC 820-10-50-2 and ASC 820-10-65-9 (Issue 17)[158] that eliminate the indefinite deferral of the effective date of certain disclosure requirements for employee benefit plans and provide that an employee benefit plan that is not subject to SEC reporting requirements is not required to provide disclosure about investments held by the

147. *Id.*
148. *Id.* at 3.
149. *Id.* at 25.
150. *Id.* at 4.
151. *Id.* at 26.
152. *Id.* at 4, 26–27.
153. *Id.* at 4.
154. *Id.* at 28.
155. *Id.* at 29.
156. *Id.* at 30.
157. *Id.* at 31–32.
158. *Id.* at 34.

employee benefit plan in any nonpublic equity securities issued by the plan's sponsor or any of the plan sponsor's nonpublic affiliated entities.[159]

(8) Offsetting Securities Borrowed and Loaned (Issue 22)[160]: The amendments to ASC 940-405, Financial Services—Brokers and Dealers—Liabilities, remove redundant guidance, which makes the guidance on offsetting more consistent, and references the guidance in ASC 210-20-45 on offsetting.[161]

(9) Fair Value of a Stable Value Common Collective Trust Fund (Issue 30)[162]: The amendments to ASC Topic 962-325, Plan Accounting—Defined Contribution Pension Plans—Investments—Other, remove the reference to a stable value common collective trust from the example in ASC Topic 962-325-55-17 to clarify that a plan should evaluate whether a readily determinable fair value exists or whether the investments qualify for the practical expedient to measure at net asset value rather than simply assuming that such an investment would have to be valued at the net asset value per share practical expedient because it would never have a readily determinable fair value.[163]

The various amendments in ASU 2018-09 have different effective dates and transition provisions depending upon the nature of each amendment.[164] Some of the amendments are effective upon issuance of ASU 2018-09 whereas others have effective dates beginning after December 15, 2018, for public business entities or, to the extent they relate to previously issued standards that are not yet effective, have effective dates consistent with those standards.[165] Issue 17 was effective upon the issuance of ASU 2018-09, without any transition guidance.[166] All of the other previously discussed issues are effective for financial statements of public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, and of all other entities for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 202.[167] The transition guidance for these issues is as follows:

- Issue 1 (taxes not payable in cash): a modified retrospective transition approach;
- Issue 4 (extinguishment of fair value debt): a prospective transition approach;
- Issue 6 (freestanding option contracts): a modified retrospective transition approach;
- Issue 7 (timing of recognition of excess tax benefits or deficiencies): a modified retrospective transition approach;

159. *Id.* at 34–35.
160. *Id.* at 43.
161. *Id.* at 6, 43–44.
162. *Id.* at 55.
163. *Id.* at 6.
164. *Id.* at 7.
165. *Id.*
166. *Id.* at 8.
167. *Id.* at 7, 61–62.

- Issue 11 (allocation of portion of tax to acquired entity): a modified retrospective transition approach;
- Issue 12 (offsetting of derivatives): a prospective transition approach;
- Issue 14 (impact of transfer restrictions on fair value): a prospective transition approach;
- Issue 16 (portfolio expansion): a prospective transition approach;
- Issue 22 (broker dealer offsetting): a modified retrospective transition approach; and
- Issue 30 (elimination of reference to collective trust fund): a modified retrospective transition approach.[168]

10. Improvements to Lease Accounting

In July 2018, the FASB issued ASU No. 2018-10,[169] which amends narrow aspects of the guidance in ASC 842 to address potential issues that could arise as organizations implement the new lease accounting standard, including issues brought to the FASB's attention by stakeholders.[170] The FASB determined to issue a separate update on these issues rather than include them in an update with other similar types of projects within the Improvements Projects to highlight the amendments and expedite the improvements.[171]

The amendments in ASU 2018-10 relate to the following sixteen issues identified in connection with the implementation of ASC 842, which the FASB adopted in ASU 2016-02:

- Residual Value Guarantees—The amendment corrects a cross reference relating to a sale and leaseback transaction.[172]
- Rate Implicit in the Lease—The amendment clarifies that a rate of zero should be used when application of the definition of the term "rate implicit in the lease" results in a rate that is less than zero.[173]
- Lessee Reassessment of Lease Classification—The amendment consolidates the requirements relating to the reassessment of the classification of a lease and clarifies that a lessee must reassess the classification of a lease when there is a change in the lease term or the assessment of a lessee option to purchase the underlying asset based on the facts and circumstances existing as of the date the reassessment is required.[174]

168. *Id.*
169. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-10, Codification Improvements to Topic 842, Leases (July 2018) [hereinafter ASU 2018-10].
170. *Id.* at 1.
171. *Id.*
172. *Id.* at 2.
173. *Id.*
174. *Id.*

- Lessor Reassessment of Lease Term and Purchase Option—The amendment clarifies that a lessor should account for the exercise by a lessee of an option to extend or terminate the lease or to purchase the underlying asset as a lease modification unless the exercise of the option is consistent with the assumptions that the lessor made in accounting for the lease.[175]

- Variable Lease Payments that Depend on an Index or a Rate—The amendment clarifies that a provision in a lease that results in a change in the variable lease payment when there is a change in a reference index or rate does not require remeasurement of the variable lease payments under the guidance relating to contingencies.[176]

- Investment Tax Credits—The amendment conforms the terminology relating to the effect of investment tax credits on the fair value of the underlying asset in the definition of "rate implicit in the lease" and the lease classification guidance.[177]

- Lease Term and Purchase Option—The amendment removes an inconsistency in two provisions in order to clarify that the lease term includes the period covered by a lessor-only option to terminate the lease.[178]

- Transition Guidance—The amendments clarify or correct the transition guidance in ASC 842 related to the following five topics: (1) amounts previously recognized for business combinations; (2) the recognition of transition adjustments to earnings rather than through equity when an entity applies ASC 842 retrospectively to each prior reporting period; (3) the correction of a reference in the provision related to leases previously classified by lessees as capital leases under ASC Topic 840, Leases ("ASC 840"); (4) the correction of a reference in the provision related to modifications to leases that a lessor previously classified as a direct financing or sales-type lease; and (5) the transition guidance for sale and leaseback transactions.[179]

- Impairment of Net Investment in the Lease—The amendment clarifies the determination of the loss allowance of the net investment in the lease.[180]

- Unguaranteed Residual Asset—The amendment clarifies that, to the extent that a lessor sells substantially all of the lease receivable associated with a direct financing lease or a sales-type lease, it should not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term.[181]

175. *Id.* at 3.
176. *Id.* at 3–4.
177. *Id.* at 4.
178. *Id.*
179. *Id.* at 4–7.
180. *Id.* at 7.
181. *Id.* at 8.

- Effect of Initial Direct Costs on Rate Implicit in the Lease—The amendment clarifies how a lessor should consider initial direct costs in determining the rate implicit in the lease for lease classification purposes.[182]
- Failed Sale and Leaseback Transaction—The amendment clarifies that a seller-lessee in a failed sale and leaseback transaction should adjust the interest rate on its financial liability as necessary to ensure that the interest on the financial liability does not exceed the total payments on the financial liability.[183]

The amendments are effective upon the effective date of the new lease accounting standard in ASU 2016-02 and pursuant to the transition provisions in that update.[184] If an entity has adopted the new lease accounting standard early, ASU 2018-10 is effective upon its issuance.[185]

11. Lease Accounting—Comparative Reporting Upon Initial Application and Lessors' Accounting for Non-Lease Counter Components

In July 2018, the FASB issued ASU No. 2018-11,[186] which addresses stakeholders' questions relating to the transition requirement that all comparative financial statements comply with the new lease accounting standard (ASC 842) upon the initial application of the standard and lessors' questions about the requirement to separate lease and nonlease components in a contract.[187]

With respect to the transition requirement, ASU 2018-11 provides an additional optional transition method that permits an entity to recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period in which it adopts ASC 842 rather than using the modified retrospective transition method in which it must apply the new standard at the beginning of the earliest period presented in the financial statements.[188] This means, for example, that an entity that adopts ASC 842 as of January 1, 2019, the effective date for calendar year-end public business entities, can elect to apply the standard as of January 1, 2019, and not the latter of January 1, 2017, the beginning of the earliest period for which financial statements are presented, or the lease commencement date, as required by the modified retrospective transition method.[189] An entity that elects the optional transition method must continue to comply with ASC 840 for those years prior to the adoption year, including the disclosure requirements in ASC 840.[190]

182. *Id.*
183. *Id.* at 9.
184. *Id.*
185. *Id.*
186. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-11, Leases (Topic 842): Targeted Improvements (July 2018) [hereinafter ASU 2018-11].
187. *Id.* at 1.
188. *Id.* at 1–2.
189. *Id.* at 28.
190. *Id.* at 3.

With respect to the amendments relating to the separation of the components of a contract by a lessor, ASU 2018-11 adds a practical expedient for lessors that is similar to that provided in ASU 2016-02 for lessees, which enables lessees, by class of underlying asset, to not separate nonlease components from the associated lease component and account for the combined components in accordance with ASC 842.[191] Examples of nonlease components are maintenance services or other activities that transfer a good or service to the lessee other than the right to use the underlying asset.[192] The practical expedient for lessors is limited, however, to circumstances in which (a) the nonlease component or components otherwise would be accounted for under the new revenue guidance; (b) the nonlease and lease components have the same timing and pattern of transfer; and (c) the lease component, if accounted for separately, would be classified as an operating lease.[193] If an entity elects the practical expedient to combine the nonlease and lease components but the nonlease component or components are the predominant component of the contract, the entity must account for the contract (the combined component) in accordance with ASC 606.[194] If the conditions in the practical expedient for lessors are met and the nonlease component or components are not the predominant component of the contract, the lessor would account for the combined component as an operating lease under ASC 842 and provide certain disclosures.[195] The new disclosures include information about the nature of the nonlease and lease components that were combined and whether ASC 606 or ASC 842 was applicable.[196]

The amendments in ASU 2018-11 related to the separation of the components of a contract are effective upon the effective date of the new lease accounting standard in ASU 2016-02 and pursuant to the transition provisions in that update.[197] If an entity has already adopted the new lease accounting standard early, the entity may elect to adopt the expedient related to separating components either in the first reporting period following the issuance of ASU 2018-11 or on the original effective date of ASC Topic 842 for that entity and may apply the practical expedient either retrospectively or prospectively.[198] Any entity that elects the practical expedient related to separating components of a contract in ASU 2018-11 must apply the expedient, by class of underlying asset, to all existing lease transactions that qualify for the expedient at the date elected.[199]

191. *Id.* at 2.
192. *Id.*
193. *Id.*
194. *Id.*
195. *Id.* at 2–3.
196. *Id.* at 4.
197. *Id.*
198. *Id.*
199. *Id.*

12. Insurance Companies' Long-Duration Contracts

In August 2018, the FASB issued ASU No. 2018-12,[200] which addresses stakeholders' concerns that existing disclosure requirements about long-duration contracts issued by insurance companies do not result in sufficiently decision-useful information in a timely or transparent manner.[201] The FASB believes that the targeted amendments in ASU 2018-12 will meet the objective of providing meaningful improvements to the financial reporting of insurance entities.[202] ASU 2018-11 states that these amendments, which are described briefly below:

- improve the timeliness of the recognition of changes in the liability for future policy benefits and modify the rate used to discount future cash flows;
- simplify and improve the accounting for certain market-based options or guarantees associated with deposit (or account balance) contracts;
- simplify the amortization of deferred acquisition costs; and
- improve the effectiveness of the required disclosures.[203]

1. Assumptions used to measure the liability for future policy benefits for traditional and limited-payment contracts: Current accounting provisions preclude any change in the original assumptions used to measure the liability for future policy benefits unless a premium deficiency is identified.[204] The amendments eliminate the requirement for testing of the risk of adverse deviation and premium deficiency (or loss recognition) and, instead, require an insurance entity to review, at least annually, and if there is a change, update the assumptions used to measure cash flows and update the discount rate assumption at each reporting date.[205] If, as a result of updating the cash flow assumptions, there is a change in the liability estimate, the changes must be recognized in net income.[206] If, as a result of updating the discount rate assumption, there is a change in the liability estimate, that change must be recognized in other comprehensive income.[207] The amendments also require an insurance entity to discount expected future cash flows at an upper-medium grade (low-credit-risk) fixed-income instrument yield that maximizes the use of observable market inputs.[208]

2. Measurement of market risk benefits—Current accounting provisions permit the use of either a fair value model or an insurance accrual model to account for the capital market risk in certain market-based options or guarantees associated

200. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-12, Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts (Aug. 2018) [hereinafter ASU 2018-12].
201. *Id.* at 1.
202. *Id.*
203. *Id.*
204. *Id.* at 2.
205. *Id.*
206. *Id.*
207. *Id.*
208. *Id.*

with deposit (or account balance) contracts.[209] The amendments require that an insurance entity measure all market risk benefits associated with deposit (or account balance) contracts at fair value and recognize any change in fair value attributable to a change in the instrument-specific credit risk in other comprehensive income.[210]

3. Amortization of deferred acquisition costs—Current accounting provisions provide for multiple amortization methods, including some that are complex and require numerous inputs and assumptions.[211] The amendments simplify the amortization of deferred acquisition costs and other balances by providing that they should be amortized on a constant level basis over the expected term of the related contracts.[212] Deferred acquisition costs are not subject to an impairment test but must be written off for unexpected contract terminations.[213]

4. Disclosures—Current accounting provisions include limited disclosure requirements.[214] The amendments require an insurance entity to disclose disaggregated rollforwards of beginning to ending balances of the liability for future policy benefits, policyholder account balances, market risk benefits, separate account liabilities, and deferred acquisition costs as well as information about, including changes and the effect on measurement resulting from changes in, significant inputs, judgments, assumptions, and methods used in measuring those amounts.[215]

The amendments are effective for financial statements of public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020.[216] For all other entities, the amendments are effective for financial statements for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.[217] Early adoption is permitted.[218] Different transition requirements apply to the different amendments. The amendments related to the liability for future policy benefits and deferred acquisition costs must be applied to contracts in force as of the beginning of the earliest period presented although retrospective application is permitted based on actual historical experience information as of contract inception.[219] The amendments related to market risk benefits must be applied retrospectively as of the beginning of the earliest period presented but an insurance entity may use hindsight in the event that prior period assumptions are unobservable or otherwise unavailable and cannot be independently substantiated.[220]

209. *Id.*
210. *Id.*
211. *Id.* at 3.
212. *Id.*
213. *Id.*
214. *Id.*
215. *Id.*
216. *Id.* at 4.
217. *Id.*
218. *Id.*
219. *Id.* at 3–4.
220. *Id.* at 4.

13. Fair Value Measurement Disclosures

In August 2018, the FASB issued ASU No. 2018-13,[221] which adopts amendments to the disclosure requirements related to fair value measurements as a part of the FASB's disclosure framework project.[222] The FASB proposed the fair value disclosure amendments to test the disclosure concepts included in a proposed "FASB Concepts Statement, Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements."[223] The FASB's proposed disclosure framework concepts statement is intended to improve the effectiveness of the notes to financial statements by articulating a framework designed to promote clear disclosure of information important to users.[224] The framework is expected to enhance the consistency of decisions by the FASB about disclosure requirements and the appropriate exercise of discretion by reporting entities (the "Disclosure Framework Project").[225] The fair value disclosure amendments reflect the FASB's evaluation of the proposed disclosure concepts, including the costs and benefits of the required disclosures, prior to its issuance of the final disclosure concepts statement on August 28, 2018.[226] The FASB expects to use the final disclosure concepts statement in the establishment of disclosure requirements in future accounting standards as well as in any future review of prior disclosure requirements.[227]

The amendments to the fair value disclosure requirements in ASC 820 remove certain disclosures, modify other disclosures, and add certain disclosures.[228] These changes are the following:

- Removed disclosures:
    1. The amount of, and reasons for, transfers between Level 1 and Level 2 of the fair value hierarchy;
    2. The policy for timing of transfers between levels;
    3. The valuation processes for Level 3 fair value measurements; and
    4. For nonpublic entities, the changes in unrealized gains and losses for the period included in earnings for recurring Level 3 fair value measurements held at the end of the reporting period.[229]

221. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement (Aug. 2018) [hereinafter ASU 2018-13].
222. *Id.* at 1.
223. *Id.*
224. *Id.*
225. *Id.*
226. *Id.*
227. *Id.*
228. *Id.* at 2.
229. *Id.*

- Modified disclosures:
    1. In lieu of a rollforward for Level 3 fair value measurements, a non-public entity is required to disclose transfers into and out of Level 3 of the fair value hierarchy and purchases and issues of Level 3 assets and liabilities.[230]
    2. For investments in certain entities that calculate net asset value, an entity is required to disclose the timing of liquidation of an investee's assets and the date when restrictions from redemption might lapse *only* if the investee has communicated the timing to the entity or announced the timing publicly.[231]
    3. The amendments clarify that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date.[232]
- New disclosures:
    1. The changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period; and
    2. The range and weighed average of significant unobservable inputs used to develop Level 3 fair value measurements.[233] For certain unobservable inputs, an entity may disclose other quantitative information (such as the median or arithmetic average) in lieu of the weighted average if the entity determines that other quantitative information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop Level 3 fair value measurements.[234]

In addition, the FASB eliminated the phrase "at a minimum" from the phrase "a reporting entity shall disclose at a minimum," which appears in ASC 820-10-50-2 related to disclosures about each class of assets and liabilities measured at fair value and ASC 820-10-50-6A related to disclosure about the fair value measurement of certain investments.[235] The FASB explained that this change was intended to "promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures and to clarify that materiality is an appropriate consideration of entities and their auditors when evaluating disclosure requirements."[236]

The amendments are effective for financial statements of all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15,

230. *Id.*
231. *Id.*
232. *Id.*
233. *Id.* at 3.
234. *Id.*
235. *Id.* at 3, 7, 11.
236. *Id.* at 3.

2019.[237] The new disclosures and the measurement uncertainty disclosure should be provided on a prospective basis for only the most recent interim or annual period presented at the time of the initial adoption of the standard.[238] All of the other amendments must be provided retrospectively to all periods presented upon their effective date.[239] An entity is permitted to adopt the amendments before the effective date, but can delay adoption of the new disclosure requirements while adopting any removed or modified disclosures.[240]

14. Disclosures About Defined Benefit Pension and Other Postretirement Plans

In August 2018, the FASB issued ASU No. 2018-14,[241] which adopts amendments to the disclosure requirements related to fair value measurements as a part of the Disclosure Framework Project.[242] The amendments reflect the FASB's evaluation of the proposed disclosure concepts evaluated in the Disclosure Framework Project, including the costs and benefits of the required disclosures, prior to its issuance of the final disclosure concepts statement on August 28, 2018.[243]

The amendments, which apply to employers that sponsor defined benefit pension or other postretirement plans, remove, add, or clarify certain of the disclosure requirements in ASC Subtopic 714-20.[244] The amendments remove the following disclosures:

- The amounts in accumulated other comprehensive income expected to be recognized as components of net periodic benefit cost over the next fiscal year;
- The amount and timing of plan assets expected to be returned to the employer;
- Disclosures related to the Japanese Welfare Pension Insurance Law;
- Related party disclosures about the amount of future annual benefits covered by insurance and annuity contracts and significant transactions between the employer or related parties and the plan;
- For nonpublic entities, the reconciliation of the opening balances to the closing balances of plan assets measured on a recurring basis in Level 3 of

237. *Id.* at 3.
238. *Id.*
239. *Id.*
240. *Id.*
241. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-14, Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans (Aug. 2018) [hereinafter ASU 2018-14].
242. *Id.* at 1.
243. *Id.*
244. *Id.* at 1–2.

the fair value hierarchy but disclosure of the amounts of transfers into and out of Level 3 and purchases of Level 3 plan assets will be required; and

- For public entities, the effects of a one-percentage-point change in assumed health care cost trend rates on the (a) aggregate of the service and interest cost components of net periodic benefit costs and (b) benefit obligation for postretirement health care benefits.[245]

The amendments add the following disclosures:

- The weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates; and
- An explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period.[246]

The amendments clarify that the disclosures required by ASC 715-20-51-3 are the following:

- For plans with projected benefit obligations that exceed the plan assets, disclosure of the projected benefit obligation and the fair value of plan assets.
- For plans with accumulated benefit obligations that exceed the plan assets, the amount of the accumulated benefit obligation and the fair value of plan assets.[247]

The amendments are effective for financial statements of public business entities for fiscal years ending after December 15, 2020, and of all other entities for fiscal years ending after December 15, 2021.[248] Early adoption is permitted and the amendments must be applied on a retrospective basis to all periods presented.[249]

15. Hedge Accounting—The Secured Overnight Financing Rate Overnight Index Swap Rate as a Benchmark Interest Rate

In October 2018, the FASB issued ASU No. 2018-16,[250] which addresses the recommendation made by the Federal Reserve Board and the Federal Reserve Bank of New York (the "Fed") that the FASB identify the Overnight Index Swap ("OIS") Rate based on the Secured Overnight Financing Rate ("SOFR")

245. *Id.* at 2.
246. *Id.*
247. *Id.*
248. *Id.* at 3.
249. *Id.*
250. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-16, Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes (Oct. 2018) [hereinafter ASU 2018-16].

as a new eligible U.S. benchmark interest rate for purposes of applying hedge accounting under ASC 815, Derivatives and Hedging ("ASC 815").[251] The SOFR is a volume-weighted median interest rate that is calculated daily based on overnight transactions from the prior day's trading activity in specified segments of the U.S. Treasury repurchase agreement (repo) market.[252] The FASB believes that including this new U.S. benchmark interest rate will facilitate the transition from the LIBOR to SOFR and enable entities to prepare for changes in interest rate risk hedging strategies for both risk management and hedge accounting purposes.[253]

The Fed's recommendation that the FASB add the additional eligible benchmark interest rate resulted from the activities of the Alternative Reference Rates Committee (the "ARRC"), which the Fed had convened to identify a suitable alternative to the U.S. dollar (USD) LIBOR because of concerns about the sustainability of LIBOR.[254] The ARRS had identified the SOFR as its preferred alternative and the Fed began publishing that daily rate on April 3, 2018.[255] The Fed and the AARC stated that the inclusion of the OIS Rate based on SOFR as an eligible benchmark rate for hedge accounting purposes is important in facilitating broader use of the underling SOFR rate in the marketplace.[256]

Prior to the issuance of ASU 2018-16, the eligible benchmark interest rates for purposes of hedge accounting were the interest rates on direct Treasury obligations of the U.S. government, the LIBOR swap rate, the OIS Rate based on the Fed Funds Effective Rate, and the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate.[257] The OIS Rate based on SOFR is similar to the OIS Rate based on the Fed Funds Effective Rate, which is a swap rate based on the underlying overnight Fed Funds Effective Rate.[258]

ASU 2018-16 adopts amendments to the Master Glossary in the Codification primarily to define "Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate."[259] In addition, ASU 2018-16 revises ASC 815-20, Derivatives and Hedging—Hedging—General Recognition ("ASC 815-20"), to add the "Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate" as an eligible benchmark interest rate for purposes of applying hedge accounting under ASC 815.[260]

The amendments are effective at the same time as the effective dates for ASU 2017-12.[261] For public business entities that have already adopted ASU 2017-12,

251. *Id.* at 1.
252. *Id.*
253. *Id.* at 2.
254. *Id.* at 1.
255. *Id.*
256. *Id.*
257. *Id.* The FASB added the SIFMA Municipal Swap Rate as an eligible benchmark rate in ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities (Aug. 2017) [hereinafter ASU 2017-12]. *Id.*
258. *Id.*
259. *Id.* at 3.
260. *Id.* at 4.
261. *Id.* at 2. As noted in *Accounting Developments 2017,* ASU 2017-12 is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15,

the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.[262] For all other entities that have already adopted ASU 2017-12, ASU 2018-16 is effective for financial statements for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.[263] Early adoption is permitted in any interim period if an entity already has adopted ASU 2017-12.[264] The amendments must be adopted on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after the date of adoption.[265]

16. Variable Interest Entities and Related Parties

In October 2018, the FASB issued ASU No. 2018-17,[266] which addresses stakeholders' observations that the guidance in ASC 810 related to variable interests could be improved as that guidance applies to private companies under common control and as that guidance applies to the evaluation of whether fees paid to decision makers and service providers are variable interests.[267] The amendments applicable to private companies apply to all entities other than public business entities and not-for-profit entities as defined in the Master Glossary of the Codification and employee benefits plans within the scope of the following ASC Topics related to plan accounting: Topic 960, Plan Accounting—Defined Benefit Pension Plans; Topic 962, Plan Accounting—Defined Contribution Pension Plans; and Topic 965, Plan Accounting—Health and Welfare Benefit Plans.[268] The provisions related to fees paid to decision makers and service providers apply to all entities that are required to determine whether they should consolidate a legal entity under the guidance related to variable interest entities ("VIEs") included in ASC 810-10, Consolidation—Overall.[269]

The provisions related to private companies expand the scope of the current accounting alternative available to private companies in common control leasing arrangements to provide that a private company may elect not to comply with the VIE guidance with respect to legal entities under common control (including common control leasing arrangements) if both the parent and the legal entity are not public business entities.[270] If a private company elects this accounting alternative, it must apply the accounting alternative to all current and future legal entities

2018, and, for other entities, for financial statements for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. 73 Bus. Law. 849, 869 (2017).

262. ASU 2018-16, *supra* note 250, at 2.

263. *Id.*

264. *Id.*

265. *Id.*

266. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-17, Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities (Oct. 2018) [hereinafter ASU 2018-17].

267. *Id.* at 1.

268. *Id.*

269. *Id.*

270. *Id.* at 1–2. In order to do this, ASU 2018-17 supersedes the amendments in Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-07, Consolidation (Topic 810): Applying

under common control that meet the criteria for applying the alternative[271] and must apply other consolidation guidance, particularly the voting interest guidance, to legal entities under common control unless another scope exception applies.[272] A private company that relies on the accounting alternative must provide detailed disclosures about its relationship to the legal entity under common control.[273]

The amendments related to decision-making fees provide that indirect interests held by a decision maker or service provider through related parties in common control arrangements should be considered on a proportional basis in determining whether the fees that the decision maker or service provider receives are variable interests.[274] This approach is consistent with the current requirements applicable to the consideration of whether an entity that holds indirect interests through related parties under common control must consolidate the VIE.[275] The FASB believes that the amendments will reduce the circumstances when a decision-making fee is considered to be a variable interest and when a decision maker with insignificant direct and indirect interests could be deemed the primary beneficiary of a VIE.[276]

The amendments are effective for financial statements of entities other than private companies for financial statements for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.[277] The amendments are effective for financial statements of a private company for financial statements for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.[278] Early adoption is permitted.[279] The amendments must be applied on a retrospective basis with a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented.[280]

17. Collaborative Arrangements

In November 2018, the FASB issued ASU No. 2018-18,[281] which addresses the uncertainty as to the effect of ASC 606 on the accounting for collaborative arrangements, which are covered by ASC Topic 808, Collaborative Arrangements ("ASC 808").[282] ASC 808-10-15-4 provides that a collaborative arrangement within

Variable Interest Entities Guidance to Common Control Leasing Arrangements, a consensus of the Private Company Council (Mar. 2014). *Id.* at 2.

271. *Id.* at 1.
272. *Id.* at 2.
273. *Id.*
274. *Id.*
275. *Id.*
276. *Id.* at 3.
277. *Id.*
278. *Id.*
279. *Id.*
280. *Id.*
281. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-18, Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 606 (Nov. 2018) [hereinafter ASU 2018-18].
282. *Id.* at 1.

the scope of ASC 808 is one that is not primarily conducted through a separate legal entity created for that activity."[283] The FASB believes that ASU 2018-18 will improve comparability in the presentation of revenue for certain transactions between collaborative participants.[284]

The amendments in ASU 2018-18 make targeted improvements to:

- Clarify that transactions between collaborative arrangement participants should be accounted for as resulting in revenue under ASC 606 when the collaborative arrangement participant is a customer in the context of a unit of account.[285]
- Add guidance in ASC 808 relating to the determination of a unit of account, that is, a distinct good or service, for a collaborative arrangement participant to use when assessing whether the collaborative arrangement or a part of the collaborative arrangement is within the scope of ASC 606.[286]
- Prohibit the presentation of revenue from a collaborative arrangement participant that is not directly related to sales to third parties together with revenue recognized under ASC 606 if the collaborative arrangement participant is not a customer.[287] ASC 606-10-15-3 states that "[a] customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration."[288]

The amendments are effective for financial statements of public business entities for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.[289] The amendments are effective for financial statements of all other entities for financial statements for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.[290] Early adoption is permitted, other than prior to the adoption date of ASC 606, for public business entities for periods for which financial statements have not been issued and for other entities for periods that have not yet been made available for issuance.[291] The amendments must be applied on a retrospective basis with a cumulative-effect adjustment to retained earnings at the later of the earliest period presented and the date of initial adoption of ASC 606.[292] An entity must disclose whether it has elected to apply the amendments in ASU 2018-18 retrospectively to all contracts or just to contracts that are not completed at the

283. *Id.* at 6.
284. *Id.* at 2.
285. *Id.* at 1–2.
286. *Id.* at 2.
287. *Id.*
288. *Id.* at 6.
289. *Id.* at 2.
290. *Id.*
291. *Id.* at 2–3.
292. *Id.* at 3.

date of initial adoption of ASC 606.[293] An entity may elect to use the practical expedient available to entities using the modified retrospective transition method in ASC 606 related to contract modifications.[294]

18. Improvements to Credit Losses Standard

In November 2018, the FASB issued ASU No. 2018-19,[295] which makes improvements[296] to ASU No. 2016-13.[297] These improvements relate to the effective date of ASU 2016-13 for nonpublic entities and the accounting for receivables arising from operating leases.[298]

Stakeholders had questioned whether the FASB had intended to require nonpublic business entities to adopt the amendments in ASU 2016-13 as of January 1, 2021, because the cumulative-effect adjustment required as of that date resulted in adoption of the amendments at the same effective time as that applicable to public business entities that do not meet the definition of an SEC filer.[299] In response, the FASB revised the effective date of ASU 2016-13 for nonpublic business entities, including not-for-profit entities within the scope of ASC Topic 958, Not-for-Profit Entities, and employee benefit plans within the scope of ASC 960 through 965 on plan accounting, to fiscal years beginning after December 15, 2021, and interim periods within those fiscal years.[300] The FASB believes that this change mitigates transition complexity by aligning the effective date for annual periods to that for interim periods.[301]

The accounting for receivables arising from operating leases is not specifically addressed in Subtopic 326-20, Financial Instruments—Credit Losses—Measured at Amortized Cost ("ASC 326-20"), the standards adopted in ASU 2016-13.[302] Stakeholders asked whether operating lease receivables would be included within the scope of ASC 326-20 because they appear to meet the definition of a financing receivable measured at amortized cost basis.[303] In ASU 2018-19, the FASB amended ASC 326-20 to state that receivables arising from operating leases are not within the scope of ASC 326-20 and, instead, should be evaluated for impairment under ASC 842, Leases.[304]

293. *Id.*
294. *Id.*
295. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-19, Codification Improvements to Topic 326, Financial Instruments—Credit Losses (Nov. 2018) [hereinafter ASU 2018-19].
296. *Id.* at 1.
297. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (June 2016) [hereinafter ASU 2016-13].
298. ASU 2018-19, *supra* note 295, at 1–2.
299. *Id.* at 2.
300. *Id.* at 1–2, 6.
301. *Id.* at 12.
302. *Id.* at 2.
303. *Id.*
304. *Id.*

The amendments are effective at the same time and the transition requirements are the same as the effective date and transition requirements in ASU 2016-13, as amended by ASU 2018-19.[305]

19. Improvements to Lessor Accounting

In December 2018, the FASB issued ASU No. 2018-20,[306] which addresses various implementation issues that lessor stakeholders reported to the FASB in applying ASC 842.[307] These issues relate to the treatment of sales taxes and other similar taxes collected from lessees, certain lessor costs, and the recognition of variable payments for contracts with lease and nonlease components.[308]

With respect to sales taxes and other similar taxes that lessors collect from lessees, lessors advised the FASB that it would be costly and complex for them to evaluate sales and other taxes on a jurisdiction-by-jurisdiction basis to determine whether those taxes are the primary obligation of the lessor as owner of the underlying asset being leased or whether the taxes are collected from a lessee on behalf of third parties.[309] ASC 842 provides that a lessor must include the amount of taxes that are the lessor's primary obligation in revenues as well as lessor costs whereas taxes that are collected on behalf of third parties are required to be excluded from lease revenue.[310] Lessor stakeholders noted that the disparate treatment of taxes would provide users of financial statements with limited financial reporting benefits because the net effect of recording taxes would be zero in the income statement.[311] In addition, lessor stakeholders noted that the FASB had provided entities with an accounting policy election to exclude amounts collected from customers for all sales and other similar taxes from the transaction price for purposes of the revenue accounting standard in ASC 606.[312] In response, the FASB has provided in ASU 2018-20 an accounting policy election for lessors similar to the relief applicable to ASC 606 implementation.[313] A lessor relying on this policy election will exclude all collections from lessees of taxes within the scope of the election from the consideration in the contract and from variable payments that are not included in the consideration in the contract and will provide certain disclosures.[314]

With respect to lessor costs paid by the lessee, lessors advised the FASB that it would be costly and complex, and potentially not possible in many situations, for them to report costs paid by lessees directly to third parties on behalf of the lessors.[315] The lessors explained that reporting such costs would provide

305. *Id.* at 3.
306. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors (Dec. 2018) [hereinafter ASU 2018-20].
307. *Id.* at 1.
308. *Id.*
309. *Id.*
310. *Id.*
311. *Id.* at 1.
312. *Id.* at 1–2.
313. *Id.* at 2.
314. *Id.* at 3.
315. *Id.* at 2.

limited financial reporting benefits because they often would be based on estimates that are affected by lessee-specific factors and information that is not readily available to the lessor and therefore may be unreliable and would result in no effect on the income statement assuming no profit margin on the costs because they would be reported as both revenue and expenses.[316] In response, the FASB adopted in ASU 2018-20 amendments that require lessors to exclude from variable payments, and thus from lease revenue, lessor costs paid by a lessee directly to a third party.[317] Where, however, a lessor pays costs excluded from the consideration in a contract and the lessee reimburses the lessor, ASU 2018-20 clarifies that a lessor must account for those reimbursed amounts as variable payments[318] and record them as revenue.[319]

With respect to variable payments for contracts with lease and nonlease components, lessors observed that the accounting treatment might require a lessor to recognize revenue for a nonlease component in a period in advance of the period in which the nonlease component is satisfied under another ASC topic, such as ASC 606.[320] ASU 2018-20 changes the accounting for these variable payments by providing that lessors must allocate, rather than recognize, certain variable payments to the lease and nonlease components when the changes in facts and circumstances on which the variable payment is based occur.[321] The variable payments allocated to the lease components must then be recognized as income in profit or loss in accordance with ASC 842 and the variable payments allocated to nonlease components must be recognized in accordance with other applicable GAAP, such as ASC 606.[322]

Entities that had not already adopted the guidance in ASC 842 before the issuance of ASU 2018-20 must comply with ASU 2018-20 at the same time and using the same transition requirements as those in ASU 2016-02 (that is, January 1, 2019, for calendar-year-end public business entities).[323] For entities that adopted ASC 842 prior to the issuance of ASU 2018-20, the transition and effective date of the amendments in ASU 2018-20 are as follows:

- An entity may either apply the amendments at the original effective date of ASC 842 or apply the amendments in either the first reporting period ending after the issuance of ASU 2018-20 (e.g., December 31, 2018) or in the first reporting period beginning after the issuance of ASU 2018-20 (e.g., January 1, 2019).[324]
- An entity may apply the amendments either retrospectively or prospectively.[325]

316. *Id.*
317. *Id.*
318. *Id.*
319. *Id.* at 4.
320. *Id.* at 3.
321. *Id.* at 4.
322. *Id.*
323. *Id.* at 4.
324. *Id.*
325. *Id.*

All entities must apply the amendments in ASU 2019-20 to all new and existing leases.[326]

B. ASUs Originated by the EITF

1. Customers' Implementation Costs Incurred in Connection with Cloud Computing Service Contracts

In August 2018, in response to an EITF consensus, the FASB issued ASU No. 2018-15,[327] which addresses stakeholders' requests for guidance on the accounting for costs of implementation activities performed in connection with a cloud computing arrangement (or hosting arrangement) that is accounted for as a service contract.[328] The FASB believes that the amendments will improve current GAAP because they will reduce diversity resulting from the absence of any explicit guidance in the area and they align the accounting for implementation costs for hosting arrangements, regardless of whether the hosting arrangement conveys a license to the hosted software.[329]

ASU 2018-15 provides that implementation, setup, and other upfront costs (referred to collectively as implementation costs) incurred by a customer in a hosting arrangement that is accounted for as a service contract because it does not involve a software license should be capitalized, consistent with the accounting treatment of implementation costs incurred to develop or obtain internal-use software, including hosting arrangements that include an internal-use software license.[330] Fees incurred under the service contract, such as training costs and certain data conversion costs, must continue to be expensed as incurred.[331]

The amendments provide that the capitalized costs must be expensed over the term of the hosting arrangement accounted for as a service contract.[332] The term of a hosting arrangement is the noncancellable period of the contract plus any additional periods within the control of the customer if it is reasonably certain that the customer will extend the term or not cancel the contract for the additional period.[333] The impairment guidance in ASC 350-40 applies to the capitalized implementation costs as if the costs were long-lived assets and the costs are subject to the guidance in ASC 360-10 on abandonment.[334]

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326. *Id.*

327. Fin. Accounting Standards Bd., Accounting Standards Update No. 2018-15, Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract (Aug. 2018) [hereinafter ASU 2018-15].

328. *Id.* at 1.

329. *Id.* at 1, 3.

330. *Id.* at 1.

331. *Id.* at 2.

332. *Id.*

333. *Id.*

334. *Id.*

ASU 2018-15 also provides the following presentation guidance for:

- the income statement—the expense related to the capitalized implementation costs must be presented in the same line item as the fees associated with the hosting element of the arrangement;
- the statement of cash flows—the payments for capitalized implementation costs must be presented in the same manner as payments made for fees associated with the hosting arrangement; and
- the statement of financial position—the capitalized implementation costs must be presented in the same line item as a prepayment for the fees associated with the hosting element of the arrangement.[335]

The amendments are effective for financial statements of public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019.[336] For all other entities, the amendments are effective for financial statements for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.[337] Early adoption is permitted, including in an interim period for which financial statements have not been issued.[338] The amendments may be applied either prospectively to all implementation costs incurred after the date of adoption or retrospectively.[339]

335. *Id.*
336. *Id.* at 3.
337. *Id.*
338. *Id.* at 3, 13–14.
339. *Id.*

Caselaw Developments 2018*

Overview

Supreme Court. The Court found that the U.S. Securities and Exchange Commission ("SEC" or "Commission") installed its administrative law judges ("ALJs") in violation of the U.S. Constitution's Appointments Clause.[1] The Court held that the Securities Litigation Uniform Standards Act ("SLUSA") does not change the concurrent jurisdiction that state courts exercise over private actions based on the Securities Act of 1933 ("Securities Act") and does not authorize the removal of such actions to federal court when plaintiffs file them in state court.[2]

Definition of a security. The Ninth Circuit determined that American Depositary Receipts ("ADRs") for Toshiba stock fell within the portion of the federal definition including "stock" as a "security."[3]

Rulemaking. The D.C. Circuit vacated the risk retention rule issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") insofar as it applies to open-market collateral loan obligation ("CLO") managers, on the ground that they do not in the course of their business ever hold the risk.[4]

Materiality. The Second Circuit held that a misrepresentation—in the case, the amount that a reseller paid to buy a security—could be material even if not directly relevant to the intrinsic value of the security where the buyer determined the price it would pay in part on the reseller's purchase price, but nevertheless reversed a conviction because the trial court improperly admitted testimony that the reseller's purchaser believed the reseller to be the purchaser's agent when, as a matter of law, that was not the case and therefore could not be believed by a reasonable investor.[5]

Duty to disclose merger discussions. The Tenth Circuit affirmed dismissal of a case against a bidder where the bidder failed to disclose to the target's equity holders that the bidder was itself involved in preliminary merger discussions, on the ground that the bidder had not—at the time of the alleged omission—demonstrated a serious commitment to that other merger and because the counterparty in that

* The caselaw developments section covers opinions decided during the calendar year 2018. Where this portion of the annual review expresses opinions, they are those of the author of the caselaw developments, William O. Fisher, and not necessarily the opinions of other authors contributing to the annual review, or of members of the subcommittee producing the review, or of the American Bar Association.

1. *See infra* notes 30–61 and accompanying text.
2. *See infra* notes 62–77 and accompanying text.
3. *See infra* notes 78–87 and accompanying text.
4. *See infra* notes 88–100 and accompanying text.
5. *See infra* notes 101–27 and accompanying text.

other merger had not, at that time, indicated that the other merger would prevent the bidder from closing on its deal with the target.[6]

Mental state necessary to violate prohibition against false statements and misleading omissions during tender offers. The Ninth Circuit held that a plaintiff can plead a violation of the first clause of section 14(e) by alleging negligence rather than scienter.[7]

Falsity of opinions. The Second Circuit affirmed dismissal of a claim against a mining company based on its expression of confidence in the work of a first expert, which the company had hired to estimate the quantity of gold that a mining project could produce, even though the company failed to disclose that a second expert, hired to conduct sample mining, quit before finishing the sampling and opined to the company that the first expert's estimate was wrong.[8]

Pleading falsity. The Tenth Circuit held that a plaintiff had not pled falsity of statements about the proprietary nature of its hardware and software and its success in discovering and defeating Russian hackers, where the complaint depended on blog posts saying these claims were false.[9]

Scienter and pleading scienter. The Fifth and Third Circuits affirmed dismissal of Rule 10b-5 claims where, for scienter pleading, the plaintiffs significantly relied on internal reports finding an inappropriate "tone at the top."[10] The Seventh Circuit found scienter allegations insufficient where an issuer restated financials because it improperly classified capital leases as operating leases,[11] and the Ninth Circuit found scienter inadequately pled where an issuer restated because it had omitted a number from a denominator in a ratio used to allocate overhead between two of its business operations.[12] The Second Circuit affirmed dismissal of a Rule 10b-5 claim against an issuer because the complaint failed to sufficiently allege scienter against the individual defendants who worked there.[13]

Coincidence of knowledge and duty to disclose when defendants are part of a business group. The Fifth Circuit held that a duty to disclose owed by one entity in a group of affiliated entities could not be attributed to another entity in that group, where that other entity possessed the information that had not been revealed.[14]

Rebutting the fraud-on-the-market ("FOTM") presumption. The Second Circuit reaffirmed its rule that, in order to successfully rebut the FOTM presumption during class certification, the defense has to show by a preponderance of the evidence that the asserted misrepresentation had no price impact, but also held that the defense need not "provide conclusive evidence that no link exists" between the misrepresentation and the price of the relevant security.[15]

6. *See infra* notes 128–71 and accompanying text.
7. *See infra* notes 172–81 and accompanying text.
8. *See infra* notes 182–97 and accompanying text.
9. *See infra* notes 198–211 and accompanying text.
10. *See infra* notes 219–63 and accompanying text.
11. *See infra* notes 264–79 and accompanying text.
12. *See infra* notes 280–95 and accompanying text.
13. *See infra* notes 296–309 and accompanying text.
14. *See infra* notes 310–21 and accompanying text.
15. *See infra* notes 322–46 and accompanying text.

Loss causation. The Ninth Circuit held that a disclosure may be corrective for loss causation purposes if it reveals the falsity of the defendants' misrepresentation, even if the disclosure does not also reveal that the defendants acted with fraudulent intent in publishing the falsehood.[16] The Eighth Circuit found no loss caused by alleged misconduct where the plaintiff was required by contract to enter into the challenged securities transaction.[17] The Fifth Circuit affirmed dismissal where it concluded the complaint pled loss resulting from the issuer's underlying misconduct rather than from misstatements or omissions about that misconduct.[18] The Second Circuit found loss causation sufficiently pled even though a trading halt delayed the price effect of the corrective disclosure.[19] The Fourth Circuit found that a company's announcement that it had received a government subpoena constituted a corrective disclosure where the complaint alleged that an analyst report connected the subpoena to the asserted fraud and the stock price dropped.[20]

The "in connection with" element. The Second Circuit held that allegations the defendant conspired to manipulate the London Interbank Offered Rate ("LIBOR") were not "in connection with" the plaintiff's purchases of fixed-rate debt, even though the plaintiff contended that it took the spread between LIBOR and fixed rates into account in making its decisions to buy fixed-rate debt.[21]

Life sciences cases. The First Circuit affirmed dismissal of a Rule 10b-5 claim against a company that disclosed the Federal Drug Administration's ("FDA") insistence on additional data and analysis before the company could file a New Drug Application ("NDA"), but did not specifically state that the FDA had requested an independent review of results at a test site.[22] The Sixth Circuit held that plaintiffs sufficiently alleged a Rule 10b-5 claim against a company that summarized a meeting with the FDA in a manner that conflicted with the FDA's minutes of that meeting, with the conflict relating to whether the company would have to conduct a long-term outcome investigation or could obtain approval based on shorter-term testing for a surrogate outcome.[23] The Ninth Circuit concluded that, by releasing positive, early interim clinical trial results, a company can impose on itself a duty to disclose later interim results suggesting no positive effect.[24]

Section 16(b) application to option packages. The Second Circuit found a defendant that wrote call options on a public company's shares and bought put options on those shares was not liable for the profit on expiration of the call options when the automatic exercise of the puts immediately before the expiration

16. *See infra* notes 354–61 and accompanying text.
17. *See infra* notes 362–73 and accompanying text.
18. *See infra* notes 374–87 and accompanying text.
19. *See infra* notes 388–97 and accompanying text.
20. *See infra* notes 398–426 and accompanying text.
21. *See infra* notes 427–45 and accompanying text.
22. *See infra* notes 450–74 and accompanying text.
23. *See infra* notes 475–506 and accompanying text.
24. *See infra* notes 507–56 and accompanying text.

of the calls left the defendant without the requisite 10 percent ownership interest necessary to liability for the profit on the calls.[25]

Extraterritoriality. The Ninth Circuit adopted the Second Circuit's analysis to determine whether a transaction is "domestic" under *Morrison v. National Australia Bank Ltd.*, but without the exception to that analysis that the Second Circuit enunciated in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*.[26]

No private right of action against issuer and management for violation of Investment Company Act ("ICA") where SEC has granted the issuer an exemption from ICA registration. The Ninth Circuit ruled that Yahoo! shareholders had no private right of action to sue for the alleged violation by the company of conditions attaching to an exemption from the ICA that the SEC had granted to Yahoo!.[27]

Supreme Court

The Supreme Court issued two securities opinions in 2018. In one, the Court held that the SEC had hired its ALJs in violation of the Appointments Clause of the U.S. Constitution.[28] In the other, the Court held that SLUSA does not deprive state courts of their jurisdiction over private securities class actions brought under the Securities Act and, further, that SLUSA does not permit removal of such cases to federal court.[29]

Appointment of SEC ALJs. Article II, section 2 of the Constitution provides that the President "shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for."[30] However, "the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments."[31] The Appointments Clause therefore applies to all Officers, but an inferior Officer can be appointed by the Head of a Department, if a statute so provides.

Section 3105 of Title 5 states that "[e]ach agency shall appoint as many administrative law judges as are necessary for proceedings required to be conducted in accordance with sections 556 and 557 of this title," which in turn provide for ALJs to "preside at the taking of evidence" and "initially decide [a] case unless the agency requires, either in specific cases or by general rule, the entire record to be certified to it for decision," with that initial decision "then becom[ing] the decision of the agency without further proceedings unless there is an appeal to, or review on motion of, the agency within time provided by rule."[32]

25. *See infra* notes 557–68 and accompanying text.
26. *See infra* notes 569–93 and accompanying text.
27. *See infra* notes 594–607 and accompanying text.
28. *See infra* notes 30–61 and accompanying text.
29. *See infra* notes 62–77 and accompanying text.
30. U.S. Const. art. II, § 2, cl. 2.
31. *Id.*
32. 5 U.S.C. §§ 556, 557, 3105 (2018).

The SEC employs ALJs.[33] SEC rules define "[d]ecisional employee" to include "[t]he administrative law judge assigned to the proceeding in question."[34] When the SEC brings an enforcement proceeding through its administrative process, the SEC typically "directs that a public hearing be held before an administrative law judge for the purpose of taking evidence."[35] That administrative "judge [then] determines whether the allegations are true and issues an initial decision within a specific time period."[36] In discharging these duties, the ALJ has "the authority to . . . : (a) [a]dminister[] oaths and affirmations; (b) [i]ssu[e] subpoenas . . . ; (c) . . . [r]ul[e] upon . . . offers of proof; (d) [r]egulat[e] the course of a [hearing] . . . ; (e) [h]old[] prehearing . . . conferences . . . ; (h) . . . [r]ul[e] upon . . . motions . . . ; [and] (i) [p]repar[e] an initial decision."[37] The ALJ has also the power to punish "[c]ontemptuous conduct," including conduct during depositions.[38]

The ALJ's initial decision includes "findings and conclusions" on "material issues of fact[and] law" and an "appropriate order, sanction, relief, or denial thereof."[39] Unless a party or aggrieved person timely petitions the Commission for review or the "Commission on its own initiative orders review," "the Commission will issue an order that the decision has become final as to that party. The decision becomes final upon issuance of the order."[40]

An SEC ALJ heard the SEC's enforcement action against Raymond Lucia and his investment company and issued an initial decision against Lucia, imposing $300,000 in civil penalties and a lifetime bar from the investment industry.[41] On its own initiative, the SEC remanded for additional factfinding, and the ALJ issued a revised initial decision including the same penalties.[42] On review of that revised decision, the SEC rejected Lucia's argument that the SEC had violated the Appointments Clause in hiring the ALJ who heard his matter, as did the D.C. Circuit.[43] The Supreme Court granted certiorari.[44]

33. The SEC may bring enforcement proceedings in either federal court, 15 U.S.C. §§ 77t(a), 78u(d)(1) (2018), or in an administrative proceeding, *id.* §§ 77h–1, 78u-3. When the SEC brings enforcement actions administratively, it typically proceeds before an ALJ. The ALJs are part of the SEC. *See* U.S. Sec. & Exch. Comm'n, Fiscal Year 2017 Agency Financial Report 8 chart 1.1 (2017) (showing Administrative Law Judges reporting to the SEC chairman).

34. 17 C.F.R. § 200.111(d)(3)(i) (2018).

35. *Office of Administrative Law Judges*, U.S. Sec. & Exchange Commission, https://www.sec.gov/page/aljsectionlanding (last visited Jan. 3, 2019).

36. *Id.*; 15 U.S.C. § 78d-1 (2018) (providing the SEC with the authority to "delegate . . . any of its functions to . . . an administrative law judge, . . . including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter").

37. 17 C.F.R. § 201.111(a) (2018). Examining witnesses is likely included within subsection (c) of the rule related to "[r]eceiving relevant evidence." *Id.*

38. *Id.* § 201.180 (permitting, with subsection (a)(1), the ALJ to exclude a person from a deposition).

39. *Id.* § 201.360(b).

40. *Id.* § 201.360(d).

41. Lucia v. SEC, 138 S. Ct. 2044, 2049–50 (2018).

42. *Id.* at 2050; Raymond J. Lucia Cos. & Raymond J. Lucia, Sr., No. 3-15006, at 2 (U.S. Sec. & Exch. Comm'n Dec. 6, 2013), https://www.sec.gov/alj/aljdec/2013/id540ce.pdf (initial decision on remand).

43. *Lucia*, 138 S. Ct. at 2050.

44. *Id.* at 2050–51.

A majority of the Court held that the SEC's ALJs were "Officers" within the meaning of the Appointments Clause.[45] In reaching that conclusion, the majority laid out two requirements for an employee to be an "Officer": (1) the "individual must occupy a 'continuing' position established by law";[46] and (2) he or she must "'exercis[e] significant authority pursuant to the laws of the United States.'"[47] All parties agreed that the SEC ALJs met the first criterion.[48]

The ALJs' extensive and important powers gave them "significant authority" so that they met the second criterion as well.[49] In so deciding, the Court relied on *Freytag v. Commissioner*, in which it had held that special trial judges ("STJs") of the U.S. Tax Court were "officers, not mere employees."[50] As do the STJs, so do the SEC ALJs have the power to take testimony, conduct trials, rule on admissibility, and enforce discovery orders.[51] Indeed, as to the effect of their initial decisions, the SEC ALJs exercise more authority than the STJs—with an ALJ decision becoming final if the Commission declines review, while an STJ decision is not final until and unless "a regular Tax Court judge . . . adopts it as his own."[52]

Since the ALJs are "Officers" within the meaning of the Appointments Clause but inferior Officers,[53] they can only be appointed by the President or a "Head[] of [a] Department[]," if a statute permits such an appointment,[54] as section 3105 of Title 5 does.[55] All parties agreed in this case that the Commission is a Head of a Department for that purpose.[56] The SEC however had not itself appointed the ALJ who tried Lucia's matter but had—as with all its ALJs—delegated the hiring to its staff.[57] Accordingly, that appointment violated the Constitution.[58]

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45. *Id.* at 2049.
46. *Id.* at 2051 (quoting United States v. Germaine, 99 U.S. 508, 511–12 (1878)).
47. *Id.* (alteration altered) (quoting Buckley v. Valeo, 424 U.S. 1, 126 (1976)).
48. *Id.* at 2053 ("Far from serving temporarily or episodically, SEC ALJs 'receive[ ] a career appointment.' 5 C.F.R. § 930.204(a) (2018). And that appointment is to a position created by statute, down to its 'duties, salary, and means of appointment.' *Freytag* [*v. Comm'r*], 501 U.S. [868,] 878 [(1991) (parallel citations omitted)]; *see* 5 U.S.C. §§ 556–557, 5372, 3105.").
49. *Id.* at 2052, 2053–54.
50. *Id.* at 2052.
51. *Id.* at 2052, 2053, with the Court's detailed comparison of the ALJs and STJs on the latter page.
52. *Id.* at 2053–54.
53. *Id.* at 2051 n.3.
54. U.S. Const. art. II, § 2, cl. 2.
55. *See supra* note 32 and accompanying text.
56. *Lucia*, 138 S. Ct. at 2051 n.3.
57. *Id.* at 2050.
58. *Id.* at 2055. The majority consisted of six justices. Justice Thomas, joined by Justice Gorsuch, concurred but regretted that the Court—while applying criteria to determine whether the ALJs displayed the characteristics *sufficient* to fall within the definition of the "Officers" to which the Appointments Clause refers—did not seize the opportunity that *Lucia* provided to set out the characteristics *necessary* to come within that definition. *Id.* at 2056–57 (Thomas, J., concurring).

The majority remanded for another hearing, but ordered that it must be conducted by an ALJ, properly appointed, other than the one who heard the matter initially, holding that the original ALJ could not do so "even if he has by now received (or receives sometime in the future) a constitutional appointment." *Id.* at 2055 (majority opinion). Three justices dissented as to that remedy. *Id.* at 2057, 2064 (Breyer, J., concurring dissenting). One justice would have reversed but avoided the constitutional question by finding that the ALJ appointments by the Commission staff violated the Administrative Procedure Act's instruction that ALJs be appointed by "each agency," with the

Significance and analysis. In *Lucia's* wake, the SEC "ratified the appointments" of its ALJs in order to "reiterate our approval of their appointments as our own under the Constitution."[59] The administration also issued an Executive Order providing "an exception to the competitive hiring rules and examinations for the position of ALJ," in part because "*Lucia* may . . . raise questions" about whether those "selection procedures are compatible with the discretion an agency head must possess under the Appointments Clause in selecting ALJs."[60] All of this may revive the debate over whether the SEC has a "home court" advantage when it pursues enforcement through an administrative proceeding instead of through a case in federal court, and whether that advantage will increase if the ALJs are more closely tied with the Commission through their appointments.[61]

SLUSA's effect on Securities Act claims filed in state court. Securities Act section 22(a) provides for concurrent federal and state court jurisdiction over actions brought under that statute, "except as provided in section [16] with respect to covered class actions" (the "except clause") and further provides that "no case arising under this [Act] and brought in any State court of competent jurisdiction shall be removed to any court of the United States" (the "no-removal clause"), again with an exception as set out in section 16.[62] Section 16, in turn, derives from SLUSA.[63] That section defines a "covered class action" as a lawsuit seeking damages on behalf of more than fifty persons and a "covered security" as one traded on a national exchange.[64] Section 16(b) then states that "[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging" either "(1) an untrue statement or omission of a material fact in connec-

SEC being "the relevant 'agency'" here. *Id.* at 2058. He expressed concern that, if the ALJs were "Officers" within the meaning of the Appointments Clause, they would be subject to the holding in *Free Enterprise Fund v. Public Co. Accounting Oversight Board*, 561 U.S. 477, 492–97 (2010), that double for-cause removal protection for officers is unconstitutional. *Lucia*, 138 S. Ct. at 2057–62 (Breyer, J., concurring & dissenting). If that were true, then the ALJs would have to be subject to removal without cause by the agencies that appointed them, "transforming administrative law judges from independent adjudicators into *dependent* decisionmakers." *Id.* at 2060.

Two justices would have held that the SEC ALJs were not "Officers" within the meaning of the Appointments Clause because they did not meet the second criterion for that category—possessing "significant authority"—a term that the dissenters would have defined to require "the ability to make final, binding decisions on behalf of the Government." *Id.* at 2064–65 (Sotomayor, J., dissenting).

59. *In re* Pending Administrative Proceedings, Securities Act Release No. 10,536, Exchange Act Release No. 83,907 (Aug. 22, 2018).

60. Excepting Administrative Law Judges from the Competitive Service, Exec. Order No. 13843, 83 Fed. Reg. 32755 (July 10, 2018), https://www.govinfo.gov/content/pkg/FR-2018-07-13/pdf/2018-15202.pdf.

61. *See supra* note 36; *see also* Stephen J. Choi & A.C. Pritchard, *The SEC's Shift to Administrative Proceedings: An Empirical Assessment*, 34 Yale J. on Reg. 1 (2017).

62. 15 U.S.C. § 77v(a) (2018).

63. Pub. L. No. 105-353, 112 Stat. 3227 (1998).

64. 15 U.S.C. § 77p(f)(2) & (3) (2018) (defining, respectively, "covered class action" and "covered security," the latter defined in part by cross-referencing section 18(b)(1) & (2), with 18(b)(1) reading: "a security designated as qualified for trading in the national market system pursuant to section [11A(a)(2) of the Securities Exchange Act of 1934 (15 U.S.C. § 78k–1(a)(2))] that is listed, or authorized for listing, on a national securities exchange").

tion with the purchase or sale of a covered security; or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security."[65] Section 16(c) states that "[a]ny covered class action brought in any State court involving a covered security, as set forth in subsection (b), shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to subsection (b),"[66] which means that it shall be dismissed after that removal.[67]

Before last year, lower courts differed as to whether section 16 precluded class actions in state courts on behalf of more than fifty investors that asserted only claims under the Securities Act.[68] In its second 2018 securities law decision, the Court addressed this question in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, as well as the related question of whether SLUSA renders such class actions removable to federal court.[69]

Employing close textual analysis and leaning as well on the notion that Congress would not have chosen the "except clause" in section 22(a) as a means to strip state courts of their long-standing ability to adjudicate Securities Act claims, Justice Kagan, writing for a unanimous Court, construed the "covered class actions" in that clause to refer to actions at which section 16, as a whole, is aimed—i.e., covered class actions, based on state statutory or common law, that allege a misrepresentation or omission, or manipulation, in the purchase or sale of a security.[70]

65. *Id.* § 77p(b).

66. *Id.* § 77p(c).

67. Kircher v. Putnam Funds Trust, 547 U.S. 633, 644 (2006).

68. *See* authorities collected in William O. Fisher, *Obligations of Attorneys in Public and Private Offerings*, *in* VENTURE CAPITAL & PUBLIC OFFERING NEGOTIATIONS ch. 36, § 5, 36-27 n.37 (Michael J. Halloran et al. eds., 3d ed. rev. 2017).

69. 138 S. Ct. 1061 (2018).

70. *Id.* at 1066, 1070. Justice Kagan rejected the view that "the except clause's reference to 'covered class actions' points the reader to, and only to, § [16](f)(2)'s definition of that term," reasoning that "the definitional paragraph . . . cannot be read to 'provide[ ]' an 'except[ion]' to the rule of concurrent jurisdiction" because "[a] definition does not provide an exception, but instead gives meaning to a term." *Id.* at 1070. Instead, the "except clause" refers to section 16 as a whole, instead of to the definition in subpart 16(f)(2), *id.* at 1071, and section 16 as a whole "bars certain securities class actions based on *state* law," *id.* at 1069.

Moving back for a wide-screen view, Justice Kagan characterized the "except clause" in section 22(a) as "a mere 'conforming amendment.' 112 Stat. 3230," and—given that "state courts had for 65 years adjudicated all manner of 1933 Act cases, including class actions"—it read too much into that clause "to believe that Congress upended that entrenched practice not by any direct means, but instead by way of a conforming amendment to § 77v(a) (linked . . . with only a definition)." *Id.* at 1071. "If Congress had wanted to deprive state courts of jurisdiction over 1933 Act class actions, it had an easy way to do so: just insert into § [16] an exclusive federal jurisdiction provision (like the 1934 Act's) for such suits." *Id.* at 1070. The Court had no textual response to the argument that, if the except clause were construed as the Court held (i.e., to except only class actions asserting state law claims for misrepresentations, omissions, or manipulation in the purchase or sale of securities), it "excepts 'exactly nothing'" since section 16 expressly precludes those suits. *Id.* at 1073 (quoting Reply Brief). Acknowledging this as "an indubitable puzzle," and that therefore "questions remain as to the except clause's precise purpose," *id.* at 1073, 1075, the Court found "no sound basis for giving the except clause a broader reading than its language can bear . . . in light of the dramatic change such an interpretation would work in the 1933 Act's jurisdictional framework," *id.* at 1075.

Accordingly, section 22(a)'s "'except clause' does nothing to deprive state courts of their jurisdiction to decide class actions brought under the 1933 Act," and "[s]tate-court jurisdiction over 1933 Act claims . . . continues undisturbed."[71] The Court therefore affirmed the California Superior Court decision denying the defense motion to dismiss the plaintiff's complaint alleging only Securities Act class-action claims.[72]

Oddly, the federal government argued in an amicus brief that, although the except clause did not strip state courts of their section 22 jurisdiction to entertain Securities Act claims, SLUSA's removal provision trumped the section 22 no-removal clause.[73] Justice Kagan rejected this "halfway-house position,"[74] on much the same reasoning as she employed on the first issue: SLUSA's section 16(c) provides for removal of "[a]ny covered class action brought in any State court involving a covered security, *as set forth in subsection (b)*."[75] Since the "covered class actions described in § [16](b)" are "*state-law* class actions," it is only to those actions that subsection (c)'s removal authority applies.[76] But "*federal-law* suits like this one—alleging only 1933 Act claims—are not 'class action[s] . . . as set forth in subsection (b)'" and therefore "remain subject to the 1933 Act's removal ban."[77]

Courts of Appeals

Definition of a security. Both the Securities Act and the Securities Exchange Act of 1934 ("Exchange Act") include "stock" within the definition of "security."[78] In *Stoyas v. Toshiba Corp.*, the Ninth Circuit held that American Depositary Receipts ("ADRs") for Toshiba common stock were "stock" as that term is used in that definition.[79] The ADRs were issued by depositary banks as beneficial interests in Toshiba shares held by the banks.[80] Applying the test set out in *Landreth Timber Co. v. Landreth* that an instrument called "stock" falls within that term for federal securities law purposes if the instrument "possess[es] 'some of the

71. *Id.* at 1069.

72. *Id.* at 1066, 1068, 1078. The Superior Court denied the defense motion for judgment on the pleadings. The California Court of Appeal denied a petition for a writ of mandate, prohibition, or other relief, and the California Supreme Court denied discretionary review. Brief for Petitioners, Cyan, Inc. v. Beaver Cnty. Emps. Ret. Fund, 138 S. Ct. 1061 (2018) (No. 15-1439), 2017 WL 3773872, at *9–10.

73. *Cyan*, 138 S. Ct. at 1075.

74. *Id.*

75. *Id.* (emphasis added) (quoting 15 U.S.C. § 77p(c)).

76. *Id.* (internal citation omitted).

77. *Id.* Justice Kagan added: "At bottom, the Government makes the same mistake as Cyan: It distorts SLUSA's text because it thinks Congress simply must have wanted 1933 Act class actions to be litigated in federal court." *Id.* at 1078.

78. 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2018).

79. 896 F.3d 933, 939–42 (9th Cir. 2018), *petition for cert. filed*, No. 18-486 (Oct. 15, 2018).

80. *Id.* at 940. At one point, the court characterized the ADRs as "negotiable certificates." *Id.* At another, the Ninth Circuit called them "contracts" between the buyers and the depositary institutions. *Id.* at 941 (citing Additional Form F-6 Eligibility Requirement, Securities Act Release No. 8287, Exchange Act Release No. 48,482, 68 Fed. Reg. 54644, 54645 (Sept. 17, 2003)).

significant characteristics typically associated with' stock,"[81] the court of appeals found the ADRs to display all five of the characteristics that *Landreth* identified.[82] They yielded dividends because the "depositary institutions transfer[red] the dividends they receive[d] on deposited Toshiba common stock to the corresponding Toshiba ADR owner."[83] They were negotiable because "they [were] traded through U.S. broker-dealers."[84] "[N]othing in the . . . ADRs restrict[ed] pledging or hypothecation."[85] ADR holders could vote the underlying shares by instructions to the depositaries.[86] The value of the ADRs changed "in tandem" with the price of Toshiba common stock, and they therefore had the capacity to increase in value.[87]

Rulemaking. Dodd-Frank required multiple financial regulators "to prescribe regulations to require 'any securitizer' of an asset-backed security to retain a portion of the credit risk for any asset that the securitizer 'transfers, sells, or conveys' to a third party, specifically 'not less than 5 percent of the credit risk for any asset.'"[88] A financial industry group challenged the application of the resulting risk-retention regulation[89] to managers of CLOs.[90]

The chain of transactions culminating in a CLO begins with multiple banks that form a syndicate to originate large dollar loans to highly leveraged companies.[91]

81. 471 U.S. 681, 686 (1985) (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975)).

82. *Stoyas*, 896 F.3d at 941.

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.* at 939–41. Three other decisions addressed the federal definition of "security." The Sixth Circuit found an investment vehicle styled a "net royalty" oil and gas lease to fall within the portion of the federal definition that refers to a "certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease." United States v. Ramer, 883 F.3d 659, 683 (6th Cir. 2018), *cert. denied*, 139 S. Ct. 111 (2018) (mem.), *reh'g denied*, 139 S. Ct. 1242 (2019) (mem.); 15 U.S.C. § 78c(a)(10) (2018). The Ninth Circuit found interests in a general partnership to fall within the portion of the definition that refers to "investment contract" where the promoter made the key decisions affecting profitability before the partnership agreements took effect. SEC v. Schooler, 905 F.3d 1107, 1110–14 (9th Cir. 2018). The Fifth Circuit similarly held that interests in a gas drilling general partnership were investment contracts where "the governing venture documents gave investors some theoretical power to control the drilling projects," but the power was "illusory in practice" because "[t]he investors never held a meeting[,] . . . did not vote on any matter," and the promoter "gave the investors little to no information." SEC v. Sethi, 910 F.3d 198, 203–05 (5th Cir. 2018).

88. Loan Syndications & Trading Ass'n v. SEC, 882 F.3d 220, 221 (D.C. Cir. 2018) [hereinafter *Loan Syndications II*] (quoting 124 Stat. 1376, 189, § 941 (2010)); 15 U.S.C. § 78o-11(b) (2018). The 2018 decision marked the second time the industry challenge to the risk-retention rule generated a D.C. Circuit opinion. In 2016, the court held that the Exchange Act sections providing for judicial review of SEC orders and rules did not create jurisdiction for review of the risk-retention rule because those sections provided for review of actions taken exclusively by the SEC, and the risk-retention rule was promulgated jointly by multiple agencies, including but not limited to the Commission. Loan Syndications & Trading Ass'n v. SEC, 818 F.3d 716, 719 (D.C. Cir. 2016). The appellate court therefore transferred the challenge to the D.C. District Court. *Id.* at 724. The opinion described in the text reversed the district court decision in favor of the agencies. *Loan Syndications II*, 882 F.3d at 222, 229.

89. *Loan Syndications II*, 882 F.3d at 221 (citing 12 C.F.R. § 244.9; 17 C.F.R. § 246.9).

90. *Id.*

91. *Id.* at 223.

The syndicates then sell the loans in a secondary market in which the buyers include "a range of investors, including institutional investors, hedge fund managers, and, of course, CLO [special purpose] vehicles" ("SPVs").[92] Each CLO is run by a manager that selects the syndicated loans that the SPV is going to buy and directs the SPV to issue its own debt securities to raise money with which to buy those loans.[93]

In reversing the district court's summary judgment granted to the promulgating agencies and remanding with instructions "to vacate the rule insofar as it applies to open-market CLO managers,"[94] the D.C. Circuit reasoned that those managers "neither originate the loans nor hold them as assets at any point."[95] To surmount the difficulty of requiring CLO managers to *retain* risk that they do not *hold* in the first instance, the agencies offered two arguments. First, the agencies claimed that the managers "transfer" risk by causing the syndicated loans to transfer to the SPVs.[96] But the D.C. Circuit concluded that

> the specific context is § 941's imposition of a risk retention rule on entities that "*sell* or transfer" assets to the issuer, indicating that Congress had in mind the ordinary sense of a conveyance between two parties, whether the conveyor was acting for financial remuneration ("sell") or was merely shifting economic value between or among an entity and its subsidiaries or affiliates ("transfer").[97]

The phrase did "not seem to apply to a person or firm that causes an SPV, whose value belongs to the investors, to make an open-market *purchase* from wholly independent third parties."[98] Second, the agencies argued that CLO managers fell within section 941's coverage because the law reached to participants who "directly or indirectly" sell or transfer the relevant risk.[99] The court ruled, however, that this phrase could not effectively impute ownership to one without it, finding it "an astonishing stretch of language to read a mandate to 'retain' to apply to one who would never *hold* the item at all apart from the mandate, with *no* congressional text mandating the prior acquisition."[100]

Materiality. In a sequel to a criminal conviction that the Second Circuit overturned in 2015, that court considered in 2018 the conviction of Jesse Litvak after remand.[101] The jury convicted Litvak in the retrial on one of ten counts charging

92. *Id.*
93. *Id.*
94. *Id.* at 229.
95. *Id.* at 223.
96. *Id.* at 224.
97. *Id.*
98. *Id.*
99. *Id.* at 225 (quoting 15 U.S.C. § 78o-11(a)(3)(B), which "refers to one who organizes an asset-backed securities transaction 'by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer'").
100. *Id.*

The D.C. Circuit also rejected policy arguments that the agencies proffered, which focused on the asserted ease with which participants could avoid the risk retention rule if it did not apply as broadly as the regulators wished. *Id.* at 226–29.

101. United States v. Litvak, 889 F.3d 56, 58–59 (2d Cir. 2018).

violation of section 10(b) of the Exchange Act.[102] That count required that the government prove the materiality of the false statement Litvak made.[103]

Litvak was a bond trader at Jefferies & Company ("Jefferies").[104] In the transaction leading to his conviction, he had lied to the representative of a purchaser of a residential mortgage-backed security ("RMBS") about the price that Jefferies had paid to buy the RMBS that Litvak was selling on to the purchaser.[105] On appeal, Litvak contended that the government failed to prove that his misrepresentation to the purchaser was material because the purchaser "agreed to a price for the bond that was based on [the purchaser's] internal analysis of value [that was] completed before [the purchaser] spoke to [Litvak]."[106]

The Second Circuit rejected this argument on the ground that it confused materiality with reliance and that a misrepresentation might be material even though it did not induce actual reliance.[107] Here, the price negotiations between Litvak and the purchaser's representative expressly centered on the *mark-up* that Jefferies would receive between the price that Jefferies had paid to buy the RMBS and the price that the purchaser would pay to buy that security from Jefferies.[108] Thus, even though Litvak's lie about the price that Jefferies paid for the security might not have affected the purchaser's view of "the intrinsic value" of the RMBS, the price that the purchaser would pay for the bond was important to the purchaser's decision to buy; and since Jefferies "profit [was] part of the price," "lies about it [could] be found by a jury" to be material under the legal standard that information is material when it alters the "total mix" of facts available and relevant to the purchaser's decision.[109]

The Second Circuit nevertheless reversed Litvak's conviction[110] because the trial court admitted testimony from the purchaser's representative that he believed Litvak was acting as the agent of the purchaser in the transaction and the government argued that that testimony was relevant to materiality.[111] The government's theory was that, if the purchaser's representative thought that Litvak was an agent for the purchaser, the representative would have trusted Litvak, would have attributed more credence to Litvak's statements, and hence would have been more likely to consider those statements important.[112]

102. *Id.* at 59, 62.
103. *Id.* at 64.
104. *Id.* at 59.
105. *Id.* at 62–63.
106. *Id.* at 65.
107. *Id.* at 66. The conversations between Litvak and the representative of the purchaser occurred because RMBSs were not sold in an impersonal market but resulted from buyer/seller negotiations. *Id.* at 60. Broker-dealers and "large, sophisticated financial institutions" participated in this market, with "[m]ost, if not all, institutional investor-buyers us[ing] computer models to establish the highest amount at which they would be willing to buy or sell a particular RMBS." *Id.*
108. *Id.* at 63.
109. *Id.* at 67 (with the "total mix" language deriving from *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988)).
110. *Id.* at 59, 72.
111. *Id.* at 67–69.
112. *Id.* at 68.

The long-standing definition of materiality states that a representation is material "if there is 'a substantial likelihood that the disclosure of the omitted fact would have been viewed *by the reasonable investor* as having significantly altered the "total mix" of information made available.'"[113] Reaffirming the rule that this is an objective standard defined with reference to "the reasonable investor,"[114] the Second Circuit allowed that "[t]he standard may vary, therefore, with the nature of the traders involved in the particular market."[115] Accordingly, a victim's testimony that he or she considered a defendant's misstatement to be important "is permissible in a case like this, but only so long as the testimony about the significance of the content of a defendant's misstatements and each trader's 'own point of view' is shown to be within the parameters of the thinking of reasonable investors in the particular market at issue."[116]

In this case, the evidence was "undisputed that [Litvak] never acted as [the purchaser's] or [its representative's] agent during the trade in question," but that Litvak's firm, Jefferies, acted as a principal—buying the RMBS from one investor and selling it to another.[117] Moreover, the purchaser's representative with whom Litvak dealt "received material from [the purchaser's] legal and compliance department stating that, in transactions such as the one here, broker-dealers act as principals."[118] The testimony of the purchaser's representative that he thought Litvak was acting as the purchaser's agent was therefore "indisputably idiosyncratic and unreasonable" and could "not, therefore, [be] probative of the views of a reasonable, objective investor in the RMBS market."[119]

Even though the court instructed the jury that Litvak was not the purchaser's agent and the government characterized the agency issue as a "red herring" in closing argument, the Second Circuit held that the admission of the purchaser representative's belief that Litvak was acting as the purchaser's representative was not harmless.[120] The court of appeals reached this conclusion largely on the basis that the jury convicted Litvak only on the count on which that representative testified and that this was the only count supported by credible testimony that any of Litvak's counterparties viewed him as their agent.[121] "[T]estimony about a perceived agency relationship was the only rational reason for the jury to have convicted appellant on that count of securities fraud while acquitting him on all other counts."[122] In acquitting on the other counts, "the jury appears to have credited the substantial evidence that investment managers view

113. *Id.* at 64 (emphasis added) (quoting *Basic*, 485 U.S. at 231–32).
114. *Id.*
115. *Id.* at 64–65.
116. *Id.* at 65.
117. *Id.* at 68.
118. *Id.* at 69.
119. *Id.*
120. *Id.* at 69, 70–72.
121. *Id.* at 70.
122. *Id.* While the representative of one other counterparty testified to such a belief, his testimony was impeached by his admission "that he viewed negotiations with broker-dealers with skepticism. He also admitted that, in particular, he viewed [Litvak's] statements during one of the transactions with suspicion." *Id.* at 71.

with suspicion statements by broker-dealers in the context of arms-length transactions."[123]

Significance and analysis. In the first *Litvak* appeal, the Second Circuit reversed on the ground that the defense should have been permitted to present expert evidence that in the RMBS market—conducted between professionals and in which the institutional investors make their buy/sell decisions on the basis of complex computer models—fibs by broker-dealer representatives about the spread between the price the broker-dealer paid for a security and the price that the purchaser would pay to buy from the broker-dealer were immaterial.[124] This second *Litvak* opinion targets that notion by stating that misrepresentations about the price the broker-dealer paid for the security could be material where the negotiations over price depend on that spread.[125] This makes sense in the context of the case because the complex computer models used by institutions such as the one buying from Jefferies did not yield a single price that an institution would pay but simply established an upper boundary.[126] Therefore, misrepresentations about the spread would be material to a purchase at any *particular* price below that upper boundary.

The notion, however, that the definition of materiality is malleable from market to market—and perhaps from submarket to submarket within a market—needs careful cabining so that materiality does not, as the Second Circuit held it should not, become a kind of watered-down version of reliance, or a term defined by a "market" contrived for litigation purposes. Key to avoiding that outcome is commitment to the notion that the "reasonable investor" referenced in the definition of materiality includes a wide variety of investors using a wide variety of analyses,[127] excluding but a few, such as participants whose views are unreasonable because they rest on indisputably untenable legal understandings.

Duty to disclose merger discussions. The *Employees' Retirement System of Rhode Island v. Williams* plaintiff sued under Rule 10b-5 on behalf of those who purchased units in Williams Partners, L.P. ("WPZ") between May 13, 2015 and June 19, 2015.[128] The CEO and CFO of Williams Companies, Inc. ("Williams") made the challenged representations, and Williams owned Williams Partners GP, LLC ("Williams Partners"), which owned 60 percent of the WPZ units and served as WPZ's general partner.[129] The contested statements announced a merger agreement between Williams and WPZ, which allegedly led

123. *Id.* at 71.

124. United States v. Litvak, 808 F.3d 160, 181–85 (2d Cir. 2015).

125. *See supra* notes 108–09 and accompanying text.

126. *See supra* note 107.

127. *See* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc) ("The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders.").

128. 889 F.3d 1153, 1158, 1161 (10th Cir. 2018). At one point, the opinion refers to the equity interests in the WPZ limited partnership as "stock," *id.* at 1162, but at other points as "units," *id.* at 1158–60, 1162. Since the opinion quotes from a securities law filing identifying those equity interests as "units," *id.* at 1159, this summary uses that term.

129. *Id.* at 1151 (challenged statements); *id.* at 1158 (organizational scheme); *id.* at 1159–60.

the plaintiff class to buy WPZ units at an excessive price before the merger fell through.[130] The plaintiff named Williams, the two officers who had spoken for it, and WPZ as defendants.[131]

WPZ and Williams documented the contemplated merger in a May 12, 2015 agreement by which "Williams would no longer be a holding company that owned [units] in WPZ but instead would directly incorporate WPZ into its structure."[132] The next day, the companies jointly announced the deal, and WPZ filed a Form 8-K reciting conditions for the merger, including that the holders of a majority of WPZ units vote for the deal and that shareholders holding a majority of the voting power at Williams vote for the deal as well.[133]

In an analyst call on May 13, 2015, the Williams CEO said that he had "a very genuine smile on my face today as we completed I think what is a fantastic transaction for us," and the CFO said there was "no risk around the WPZ [unit] vote because Williams has [a] majority of the votes."[134] The slides providing supplemental information for the call listed "'[s]pecific factors that could cause actual results to differ from results contemplated by the forward-looking statements,' . . . includ[ing] '[s]atisfaction of the conditions to the completion of the proposed merger, including approval by Williams stockholders,'" and "advised investors 'not to unduly rely on our forward-looking statement[s].'"[135] Neither the Williams CEO nor the Williams CFO mentioned—during the analyst call—a possible merger by Williams with another firm, Energy Transfer Equity L.P. ("ETE").[136]

The plaintiff alleged that the statements made during the May 13 call misleadingly characterized the Williams/WPZ merger as "a done deal, . . . [with] 'no risk' that it would not be consummated."[137] The plaintiff also alleged as an omission during the call "the failure to disclose that Williams and ETE had been having discussions about a potential merger that would prevent the WPZ merger."[138]

As it happened, ETE and Williams merged after the May 13, 2015 call, and that ETE/Williams merger derailed the WPZ/Williams deal. As the court pieced it together from the allegations in the complaint and an S-4 filed by ETE,[139] ETE had contacted the Williams CEO in early 2014, expressing interest "in exploring a merger" but the Williams CEO said "that he did not believe that Williams was interested in a deal."[140] Nine months later, ETE "conveyed another expression of interest to Williams' financial advisor Barclays Capital."[141] Although Williams retained Barclays and legal counsel "to provide guidance on ETE's interest in a

130. *Id*. at 1159.
131. *Id*. at 1158.
132. *Id*. at 1159.
133. *Id*. at 1159–60.
134. *Id*. at 1160.
135. *Id*.
136. *Id*. at 1162.
137. *Id*.
138. *Id*.
139. *Id*. at 1159, 1161 & 1169 (referring to the specific S-4).
140. *Id*. at 1158–59.
141. *Id*. at 1159.

merger," the Williams' board concluded in December 2014 that "'it was not in the best interest of [Williams] stockholders to engage in discussions with ETE at that time.'"[142] In February 2015, however, the Williams CEO told the board chair of ETE's general partner "that he would convey any offer to Williams' board," adding that "Williams 'was not seeking a combination' but 'always considers strategic proposals.'"[143] On May 6, 2015, when "Williams was pursuing a plan to acquire WPZ in full," the Williams CEO told ETE that "he would discuss with his board any offer made by [ETE]."[144] ETE responded that it "would not make an offer unless [the Williams' CEO] supported it," with the result that "an offer from ETE was neither made nor requested."[145]

That is where things stood when Williams announced the merger with WPZ and conducted the May 13, 2015 conference call in which the plaintiff alleged (i) the misrepresentation that the WPZ/Williams merger was a done deal and (ii) the misleading omission of the discussions with ETE.[146] A week *after* that call, "ETE presented a written offer to acquire Williams," which "included a condition to its offer that had never been brought up in prior discussions: ETE would not merge with Williams if Williams merged with WPZ."[147] On June 21 (the Sunday after the June 19 date ending the class period), Williams rejected that offer as too low and "issued a press release announcing that it had authorized a process to explore a range of strategic alternatives following an unsolicited acquisition offer"—without identifying ETE as the offeror.[148] ETE identified itself in a press release the next day as the unnamed bidder.[149] On September 25—apparently after examining "a variety of strategic possibilities, including mergers with a number of other companies" and narrowing its options to three (ETE and two companies that did not insist on Williams abandoning its merger with WPZ)—the Williams' board "voted (with [its CEO] in the minority) to merge with ETE" and terminate its agreement with WPZ.[150]

The plaintiff claimed that it and its fellow class members were hurt by this sequence because, relying on the statements the Williams CEO and CFO made during the May 13 analyst call, they bought WPZ units at an inflated price, with their loss shown by the 7.6 percent drop in the price of WPZ units after the June announcements by Williams that it was considering an unsolicited offer and by ETE that it had made that offer.[151]

The Tenth Circuit affirmed the district court's judgment dismissing the complaint,[152] both because the complaint failed to allege either a misrepresentation

142. *Id.*
143. *Id.* (quoting from the ETE S-4).
144. *Id.*
145. *Id.*
146. *Id.*
147. *Id.* at 1160.
148. *Id.*
149. *Id.*
150. *Id.* at 1161.
151. *Id.* at 1162.
152. *Id.* at 1158–59, 1173.

or an actionable omission and because it did not include allegations raising a strong inference of scienter.[153] There was no misrepresentation that the WPZ/Williams merger was a "done deal" because, while the Williams CEO and CFO "referred to the merger in the past tense, announcing that the merger was a 'transaction [that Williams and WPZ] just got done,' one that had already been 'completed' and 'finished,'" they "made quite explicit what further steps were necessary."[154] The only statement denying risk was the CFO's remark that the requirement for a majority of WPZ units to vote for the deal posed no risk because Williams owned a majority of the units,[155] which the plaintiff did not deny. "[N]o one [on the analyst call] said that 'there existed no *present* facts—"no risk"—that posed a danger of an adverse result.'"[156]

The court then provided a more complex analysis rejecting the claim that the defendants had misled on the call by failing to mention Williams' discussions with ETE.[157] First, the court held that the defendants had no duty to disclose the discussions with ETE because the failure to reveal those discussions did not render misleading any of the statements they made about the Williams/WPZ agreement.[158] Indeed, since they "made no statement about the prospects of Williams merging with any other companies when the Williams-WPZ merger was announced," they could not have misled about those prospects.[159] Nor were their statements about the WPZ deal "inconsistent with Williams having received overtures from ETE."[160] "In particular, they did not state that the Williams-WPZ deal would be exclusive of any other merger."[161]

Second, the Tenth Circuit held that "the existence of the early merger discussions was not material information"[162] at the time of the analyst call because those discussions did not show "a serious commitment to consummate [a] transaction."[163] The chronology pled showed only "conversations and the willingness of Williams' executives to convey offers to its board[, b]ut [the complaint] fail[ed] to allege any 'concrete offers, specific discussions, or anything more than vague expressions of interest.'"[164] And, importantly, the complaint did "not allege that ETE had ever indicated before the Analysts Presentation that it could not tolerate

153. *Id.* at 1162–63.
154. *Id.* at 1163.
155. *Id.*
156. *Id.*
157. *Id.* at 1163–72.
158. *Id.* at 1164–65.
159. *Id.* at 1164.
160. *Id.* at 1165.
161. *Id.* The plaintiff contended that the defendants had a duty to update the statements they made on the analyst call "a few days later when ETE made a formal proposal to Williams." *Id.* at 1166. After expressing uncertainty as to "[w]hether there is ever such a duty to update," the Tenth Circuit reasoned that it would arise only if a later development made prior defendants' statements false. *Id.* But that had not happened because "[t]heir statements were consistent with the possibility that the WPZ merger would have to be cancelled because of a future event, such as a merger with an outside entity." *Id.* at 1167.
162. *Id.* at 1167.
163. *Id.* at 1168.
164. *Id.* at 1169 (quoting Jackvony v. RIHT Fin. Corp., 873 F.2d 411, 415 (1st Cir. 1989)).

the WPZ merger."[165] Accordingly, the complaint "only speculate[d] that WPZ investors would reasonably view such a combination as fatal to the WPZ merger."[166]

Finally, the court of appeals found no allegations raising a "strong inference" of scienter—in large part on the same reasoning that underlay the court's conclusion on materiality.

> Given the small likelihood that the ETE contacts posed a risk to the WPZ merger, one can hardly draw a "strong inference" that Defendants intended to deceive investors by failing to disclose those contacts publicly or that Defendants knew or must have been aware (because the conclusion was so obvious) that a failure to disclose would mislead investors.[167]

Significance and analysis. The Tenth Circuit based its decision in part on "the 'probability/magnitude' test for determining when preliminary merger discussions are material."[168] Focusing on the low probability of a Williams/ETE merger when the defendant officers spoke on the analyst call, the test led to the conclusion that the information about that merger was not material at the time of the call.[169] Worth noting is that, in the ordinary case, shareholders in A sue A because A did not disclose that A was discussing a merger with B.[170] In contrast, *Williams* was a suit by equity holders in C against A based on A's failure to disclose that A was talking with B about an A/B merger that ultimately scuttled an A/C merger. Consequently, while the relevant probability was the probability of the A/B merger, the relevant magnitude was not appropriately measured by the impact of the A/B merger on A but by the impact of the A/B merger on C.[171]

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165. *Id*. at 1170.

166. *Id*. At another point, the court of appeals characterized the interactions between ETE and Williams "before the Analysts Presentation . . . [as] involv[ing] no confidentiality agreements, no exchanges of financial information, and no offers." *Id*. at 1171–72.

167. *Id*. at 1172–73. The Tenth Circuit noted too that the complaint failed to allege any motive for fraud. *Id*. at 1173. Moreover, the fact that Williams "press[ed] forward" on the WPZ deal was inconsistent with scienter, as that fact "creates a 'strong inference' that it did not think the ETE overtures would lead to termination of the consolidation, not a strong inference of the scienter that Plaintiff needs to establish." *Id*.

168. *Id*. at 1168 (quoting Basic Inc. v. Levinson, 485 U.S. 224, 238 (1988)).

169. *Id*. at 1169 ("[T]he Complaint does not plausibly allege that a Williams–ETE merger was likely when the Analyst Presentation statements were made.").

170. In *Basic*, 485 U.S. at 226–28, by Basic Incorporated discussing a combination with Combustion Engineering, Inc.

171. Two other decisions addressed the duty to disclose regulatory violations. The court in *City of Cambridge Retirement Systems v. Altisource Asset Management*, 908 F.3d 872, 874, 879, 884 (3d Cir. 2018), affirmed dismissal of a Rule 10b-5 claim. The defendant managed a second company that bought non-performing mortgages, and a third company serviced those loans. *Id*. at 881. All three were "highly interrelated," with the first two spun out of the third. *Id*. at 876–77. The defendant's annual report explained the relationship between these companies and said that the second company enjoyed a "competitive advantage" due to its relationship with the third. *Id*. at 880. Those statements did not create a duty to disclose (i) the alleged obsolescence of the third company's mortgage servicing platform or (ii) the third company's regulatory problems, because (a) the defendant made no statement about the "*quality* of [the third company's] loan servicing" but only implied that the third company provided high capacity and low-cost service and (b) the "regulatory failures" were "not only well-known[,] but typical of mortgage servicers at the time." *Id*. at 881–82.

Mental state necessary to violate prohibition against false statements and misleading omissions during tender offers. Exchange Act section 14(e) makes it "unlawful for any person [(1)] to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, *or* [(2)] to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation."[172] In *Varjabedian v. Emulex Corp.*, the Ninth Circuit considered whether a violation of this statute requires more than negligence.[173]

Employing the analytical technique by which the U.S. Supreme Court determined in *Aaron v. SEC* that only one of the three subparts of Securities Act section 17(a) requires scienter,[174] the Ninth Circuit focused on the disjunctive "or" between the interlineated numbers in the rendition of 14(e) above, noted that that *first* clause does not contain words suggestive of scienter ("fraudulent, deceptive, or manipulative"), and therefore found "most compelling" the "argument . . . that the first clause of Section 14(e) requires a showing of negligence, not scienter."[175] The Ninth Circuit therefore reversed the district court's judgment insofar as it dismissed the plaintiff's section 14(e) claim, because that judgment rested on the plaintiff's failure to plead facts showing a "strong inference" of scienter.[176]

In *Jaroslawicz v. M&T Bank Corp.*, 912 F.3d 96 (3d Cir. 2018), target shareholders brought an Exchange Act section 14(a) claim against a bidder where a joint proxy statement allegedly violated Item 503(c) by failing to include as risk factors the bidder's violations of (i) consumer law and (ii) Bank Secrecy Act/anti-money laundering statutes ("BSA/AML"). *Id.* at 101, 106–12. Vacating dismissal as to this claim, *id.* at 101, 112, 115, the Third Circuit found the proxy statement wanting because it contained only generic risk language and was not "company-specific," *id.* at 111–12. As to "the consumer violations, the Joint Proxy did not make any reference to the fraudulent practice underlying the violations, the dates the practice was in place, the extent of consumer accounts affected by the practice, or the subsequent [Consumer Financial Protection Bureau] investigation into the practice." *Id.* at 111. While the proxy statement's generic references to BSA/AML were arguably cured by supplemental disclosures providing bidder-specific information six and three days before the shareholder vote, the court was "not prepared to say" that "the six days provided here was adequate as a matter of law" "for a reasonable investor to digest the information." *Id.* at 112.

172. 15 U.S.C. § 78n(e) (2018) (emphasis added).

173. 888 F.3d 399, 404–08 (9th Cir. 2018), *cert. dismissed as improvidently granted*, 2019 WL 1768137 (U.S. Apr. 23, 2019) (No. 18-459) (mem.).

174. *Id.* at 406 (citing Aaron v. SEC, 446 U.S. 680 (1980)).

175. *Id.* at 404, 407.

176. *Id.* at 401, 409–10. Note that the requirement for pleading facts raising a "strong inference" applies to any private claim under the Exchange Act "in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind," 15 U.S.C. § 78u-4(b)(2)(A) (2018), not just claims under Rule 10b-5.

The *Varjabedian* plaintiff alleged that the proxy statement distributed by Emulex, recommending that that company's shareholders tender into an offer by Avago Technologies Wireless Manufacturing, Inc., misled by including an investment banker's valuation analyses based on four techniques—"the Historical Stock Trading Analysis, the Selected Companies Analysis, the Illustrative Present Value of Future Share Price Analysis, and the Illustrative Discounted Cash Flow Analysis"—but failed to summarize a "one-page chart" that showed the premia paid in "selected certain transactions in the industry that [the investment banker] deemed most similar to the [transaction] between Avago and Emulex." *Varjabedian*, 888 F.3d at 402–03. That chart showed that "Emulex's 26.4% premium fell within the normal range of semiconductor merger premiums listed in the Premium Analysis, but it was below average." *Id.* The court of

Significance and analysis. The Ninth Circuit recognized that its holding conflicts with decisions in five other circuits.[177] As the Ninth Circuit read them, these opinions rested on analogizing 14(e) with Rule 10b-5.[178] While true that Rule 10b-5 includes multiple disjunctive prohibitions, the Supreme Court held in *Ernst & Ernst v. Hochfelder* that violation of any of the three parts requires scienter because the statute on which Rule 10b-5 is based, Exchange Act section 10(b), includes words ("manipulative or deceptive") that "strongly suggest that [§] 10(b) was intended to proscribe knowing or intentional misconduct," and the "scope [of Rule 10b-5] cannot exceed the power granted the Commission by Congress under [§] 10(b)."[179] None of the three disjunctive prohibitions in the rule could reduce the scienter that the enabling statute included without alternative. Here, on the other hand, section 14(e) itself included the disjunctive proscriptions and therefore each of them stood on its own, either including words suggesting scienter or not.

This Ninth Circuit analysis dovetails with the analysis that the Supreme Court employed in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, where Justice Kagan emphasized the disjunctive prohibitions in Securities Act section 11—and relied on the one prohibiting statements that mislead by omitting material facts in order to elaborate the third of three ways in which an opinion may be false for securities law purposes: if an opinion "omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself."[180] Even though *Varjabedian* does not cite *Omnicare*, the two decisions suggest a return to textual analysis and a willingness to rely on text to disturb what practitioners have taken to be settled decisional law. Although the Supreme Court granted review in *Varjabedian*, it later dismissed that grant as improvident, and the case will not provide a vehicle for resolving the circuit split on the necessary mental state for a 14(e) violation.[181]

Falsity of opinions. The Supreme Court held in *Omnicare* that, for securities law purposes, an opinion may be false or misleading in any one of three ways: (1) if

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appeals commented that "[a]lthough it is difficult to show that this omitted information was indeed material, we remand for the district court to consider the question in the first instance." *Id.* at 408.

In a second noteworthy tender offer decision, the Ninth Circuit held that section 14(d)(4)—which requires that "[a]ny solicitation or recommendation to the holders of such a security to accept or reject a tender offer or request or invitation for tenders shall be made in accordance with such rules and regulations as the Commission may prescribe," 15 U.S.C. § 78n(d)(4) (2018)—does not create a private right of action. *Varjabedian*, 888 F.3d at 408–09. Applying the relevant factors prescribed by the Supreme Court in *Cort v. Ash*, 422 U.S. 66, 78 (1975), the Ninth Circuit found that: (1) section 14(d)(4) "focus[es] . . . on the person regulated" rather than the person benefited by the regulation; (2) section 14(d)(4)'s language gives "no indication of any legislative intent" to create a private action; and (3) an implied right under 14(d)(4) "would be redundant" to the private right under 14(e) and "potentially cause tension with Section 14(e)." *Id.* at 408–09.

177. *Id.* at 404–05 (citing Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp., 565 F.3d 200, 207 (5th Cir. 2009); *In re* Digital Island Sec. Litig., 357 F.3d 322, 328 (3d Cir. 2004); SEC v. Ginsburg, 362 F.3d 1292, 1297 (11th Cir. 2004); Conn. Nat'l Bank v. Fluor Corp., 808 F.2d 957, 961 (2d Cir. 1987); Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 431 (6th Cir. 1980)).

178. *Id.* at 405–06.

179. 425 U.S. 185, 197, 214 (1976).

180. 135 S. Ct. 1318, 1329 (2015).

181. *See supra* note 173.

the speaker or author of the opinion does not believe it at the time of speaking or writing it; (2) if the opinion includes embedded factual statements that are false; or (3) if the opinion misleads because the speaker or writer has, at the time of speaking or writing, information that conflicts with the opinion that, taking into account the context in which the opinion is expressed, a reasonable investor would expect the speaker or author to provide.[182] In *Martin v. Quartermain*, the Second Circuit considered whether a company provided a false opinion in the third of these ways when it revealed the conclusion of one expert without disclosing the contrary conclusion of a second expert.[183]

The defendant company bought a gold-mining site.[184] It hired a first expert "to estimate the quantity of gold that the Project could produce," and that expert provided an estimate while recommending that the company conduct sample mining before full-scale mining commenced.[185] The company then hired a second expert to oversee and report on the initial mining, while publicly stating that the second expert "would report on the overall [sampling] program at its conclusion."[186] While that effort was underway, the company "reported favorable results from the sampling program and expressed continued faith in [the first expert's] estimates."[187] On the other hand, the company "emphasized the preliminary nature of its development of the Project by qualifying its press releases with a warning that any figures it disclosed would 'only be estimates,' resulting from a 'subjective process that relies on [the company's] judgment' and 'inferences that may ultimately prove to be inaccurate.'"[188]

The second expert quit before the sampling was finished and before preparing any report, and the company disclosed this development.[189] About two weeks later, the company also disclosed "[the second expert's] opinion that [the company's] previous public statements suggesting that [the first expert's] estimates remained viable were 'erroneous and misleading.'"[190] Purchasers of company stock before that disclosure sued, making a Rule 10b-5 claim and contending that the company had published opinions that "defrauded investors by expressing continued faith in [the first expert's] estimates, notwithstanding—and without disclosing—[the second expert's] view that the sampling program was not bearing out those projections."[191]

182. 135 S. Ct. 1318, 1326–32 (2015).

183. 732 F. App'x 37 (2d Cir. 2018). As to the first alternative identified in *Omnicare*, "all the relevant allegations in the complaint suggest that, despite [the second expert's] contrary opinion, [the company] believed that [the first expert's] estimates would prove accurate." *Id.* at 40–41. As to the second, "the plaintiffs do not plausibly allege that any of the facts supplied by [the company] in support of its estimates were untrue; they allege merely that [the company] should have drawn different conclusions from those facts." *Id.* at 41.

184. *Id.* at 39.

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.* at 42.

189. *Id.* at 40.

190. *Id.*

191. *Id.*

Affirming dismissal,[192] the Second Circuit held that the company's challenged opinions, "viewed in context, were not misleading."[193] While conceding that "investors '[c]ertainly . . . would have been interested in knowing about [the second expert's] feedback, and perhaps would have acted otherwise had the feedback been disclosed," the company stated that the second expert was retained "to 'oversee' the 'work required to be completed,'" and the second expert's "opinions about other matters—including its concerns about the initial results of the sampling program or how those preliminary results compared to [the first expert's] report—were not relevant to the narrow purpose for which [the company] retained [the second expert]."[194]

Significance and analysis. Within a given company, different staffers or even different staffs (e.g., sales v. financial staffs) may make different projections. And, as *Martin* shows, different outside experts hired by a given company may make different projections. But if a company repeats the projections of a first expert, while the second expert is testing them and before completing its tests comes to doubt the first expert's forecasts, a reasonable investor—as the Second Circuit found in *Martin* itself—would be interested in the second expert's interim view. It seems a stretch, particularly on a pleading motion, to dismiss such a claim based on *Omnicare*'s comment that a company need not disclose all conclusions contrary to the one it publicly expresses.[195] Justice Kagan illustrated that principle by a hypothetical in which "a single junior attorney expressed doubts" about a legal conclusion to which "six of his more senior colleagues gave a stamp of approval."[196] That seems a far cry from *Martin*, where the second expert, to which the company attributed sufficient skill to conduct sample mining and render a report at the end of sampling, allegedly advised the company (albeit before the sampling was finished)

192. *Id.* at 44.

193. *Id.* at 42.

194. *Id.* (quoting, first, from Tongue v. Sanofi, 816 F.3d 199, 212 (2d Cir. 2016)).

During the test mining, the company announced discovery of the Cleopatra Vein, "an extreme grade mineralization deposit that had been projected [in] the [first expert's] Report." *Id.* at 39 (internal quotation marks omitted). The company said it would increase the proportion of the sample mining in the project's "'higher grade' area that included the Cleopatra Vein." *Id.* While the plaintiffs contended that the company "defrauded investors by touting the results of the sampling program without disclosing that [the company] had skewed the program toward the narrow and unrepresentative Cleopatra Vein in order to yield more favorable data," "it was apparent from [the issuer's] disclosures that the Cleopatra Vein was not representative of the Project overall" and that the sample mining would oversample that vein. *Id.* at 43. Although the plaintiffs contended that the company also "defrauded investors by stating that it was planning, *with [the second expert]*, to increase the portion of the sample drawn from the Cleopatra Vein when, in fact, '[the second expert] was *not* on board with [that] plan' to 'skew' the sampling program," the Second Circuit found that, assuming this was a misstatement, it was not material. *Id.* In its statements, the company "made clear that the plan would skew the sampling program toward the atypically productive Cleopatra Vein," and hence the second expert's "actual view—that the plan would skew the program—would have merely duplicated, rather than 'significantly altered,' the mix of information before investors." *Id.* (quoting Hutchison v. Deutsche Bank Sec. Inc., 647 F.3d 479, 485 (2d Cir. 2011)).

195. Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1329 (2015) ("An opinion statement, however, is not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way." (quoted in Martin v. Quartermain, 732 F. App'x 37, 41 (2d Cir. 2018))).

196. *Id.*

that the company's continued public reliance on the projections of the first expert was misleading, and the company delayed disclosing that advice.[197]

Pleading falsity. The Exchange Act requires that—in private actions under that law claiming that a defendant has "made an untrue statement of fact" or "omitted to state a material fact necessary" to avoid misleading—plaintiffs must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, . . . state with particularity all facts on which that belief is formed."[198] The Tenth Circuit applied this pleading protocol in 2018 to affirm dismissal of a Rule 10b-5 claim brought against an issuer producing cybersecurity products and providing related services, and against its CEO and CFO.[199] The claim rested on statements saying that: (1) the company's competitive strength derived from its "proprietary hardware and software"; and (2) the company had detected and defeated a cybersecurity attack "by a state-sponsored team of Russian hackers, known as Sofacy or APT28, to target several international financial institutions"—self-praise remarkable because the company "claimed that this was 'the first and only known Sofacy attack to be discovered, identified, and reported' before the attack began."[200]

The complaint included two facts to show that the statement about "proprietary hardware and software" was false.[201] First, the plaintiff pled that an article posted on a website, by an author with the pseudonym Pump Stopper, contended "that the financial results reported for the Cyber Solutions sector of [the issuer's] business reflected 'a one-time[,] low margin hardware installation,' and the *resale* and installation of a product called Digital Shield."[202] The Tenth Circuit was unimpressed because the plaintiff could not show that the products referenced by Pump Stopper were "in fact the same products" to which the defendants attached "proprietary" as a descriptor.[203] Second, the plaintiff alleged that the issuer—after using the term "proprietary" in a number of SEC filings—then omitted that description in succeeding filings.[204] But the court of appeals pointed out that, after the defendants stopped using the general term "proprietary," they substituted language "reasonably read as providing greater details about the 'platforms and tools'—which were under development by [the issuer's] team of 'subject matter experts'"—an elaboration that did not conflict with the earlier description.[205]

197. *Martin*, 732 F. App'x at 40.
198. 15 U.S.C. § 78u-4(b)(1) (2018).
199. Hampton v. root9B Techs., Inc., 897 F.3d 1291, 1294, 1303 (10th Cir. 2018).
200. *Id.* at 1295.
201. *Id.* at 1299.
202. *Id.* at 1296 (emphasis added). Since "installation" was a service and not a product at all, "installation" could not have constituted sale of the issuer's hardware or software—whether "proprietary" or otherwise. Similarly, "resale" of another company's product could not have constituted sale of issuer's "proprietary" hardware or software.
203. *Id.* at 1299.
204. *Id.* at 1300.
205. *Id.* at 1301.

As to the company's claim that it had detected and prevented an attack by the elusive Sofacy hackers, the complaint cited a signed article on a blog site concluding that the attack was more likely part of a Nigerian-based phishing scam.[206] Although recognizing that the company's statement concerning the origin of the attack could be analyzed as an opinion, the Tenth Circuit chose to address it as a statement of fact.[207] But the court found the blog posting to provide nothing more than "an alternative attribution—i.e., potentially Nigerian scammers—and therefore falls far short of establishing that the Sofacy attribution was untrue or even misleading."[208] Digging into the details, the opinion noted that the blogger never "explicitly state[d] that the Sofacy attribution was actually untrue," addressed only some of the published reasons that the company linked the attack to Sofacy, and admitted that the issuer may have had additional evidence—that it had not published—to support sourcing the hacking to Sofacy.[209]

Significance and analysis. The Tenth Circuit decision highlights the difficulty of applying pleading rules in the Internet age. An issuer makes a statement. Some blogger—perhaps even one identifying himself or herself by a snappy nickname—posts a refutation. A shareholder puts the two together and alleges securities fraud. Courts may display understandable skepticism of the notion that this sequence should take a case past a motion to dismiss and into discovery and further motion practice—a burden to both defendants and the judicial system. But the courts must take care in how they indulge these healthy doubts.

On the one hand, a court must take factual allegations in a complaint as true for purposes of a motion to dismiss.[210] Accordingly, the court must take as true the allegation that the blogger said what the plaintiff alleges the blogger said, at least absent incorporating the blog posting into the complaint and finding that the plaintiff's description of the post is wrong. On the other hand, the court need not make every possible inference from the blog posting and appropriately dismisses claims where the alleged facts do not plausibly state a claim.[211]

In the case before it, the Tenth Circuit avoided any analysis of the blogger's credibility by using the special statutory pleading rule to justify closely parsing the words that the blogger used. But other cases may call upon courts to evaluate a blogger's bona fides in order to determine whether the post plausibly suggests that the defendants spoke falsely.

Scienter and pleading scienter. In addition to the requirement that plaintiffs allege specific facts showing that a representation was false or misled by omis-

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206. *Id.* at 1295–96.

207. *Id.* at 1301. The court said its choice gave the plaintiff the benefit of a "lower pleading hurdle." *Id.*

208. *Id.*

209. *Id.* at 1302. The blogger contested the company's reliance on a domain name to link Sofacy to the attempted intrusion because that domain name had been used in Nigerian phishing in the past. *Id.* But the blogger did not address other indicators of Sofacy's involvement on which the issuer relied—including the similarity (in targets and design) between the attack the company attributed to Sofacy and previous Sofacy attacks. *Id.*

210. *Id.* at 1297.

211. Bell Atl. Corp. v. Twombly, 550 U.S. 544, 558, 570 (2007).

sion, the Exchange Act requires a plaintiff seeking damages under that law to plead specific facts raising a "strong inference" of the "state of mind" that the law requires a defendant to have.[212] To violate Rule 10b-5, the defendant must have scienter.[213] Scienter "refers to a mental state embracing intent to deceive, manipulate, or defraud."[214] It also includes recklessness.[215]

Last year produced opinions by both the Fifth and Third Circuits addressing whether the report of an internal investigation—concluding that executives set an inappropriate "tone at the top"—provides a "strong inference" of scienter, with the defendants prevailing in each of those cases even though in each instance the issuer restated financials.[216] The Seventh and Ninth Circuits found scienter inadequately pled in other Rule 10b-5 cases based on restatements, with the Seventh Circuit action deriving from improper classification of capital leases as operating leases, and the Ninth Circuit action from omission of a number from the denominator of a ratio allocating overhead expenses between two business operations.[217] The Second Circuit affirmed dismissal of a Rule 10b-5 claim against both a corporate defendant and individuals who worked at that defendant, on the ground—as to the corporation—that the complaint failed to plead facts raising a strong inference that the individual defendants acted with scienter.[218]

Scienter and "tone at the top." Hanger, Inc. ("Hanger") provided orthotic and prosthetic patient care services.[219] Reimbursements from Medicare comprised a significant portion of its revenue.[220] Hanger failed Medicare audits and therefore had to return reimbursements that it had already recorded as revenue, and the company could only recover the returned money through a lengthy appeals process.[221] During this same period, Hanger also experienced difficulties implementing a new management system called Janus.[222]

On April 4, 2014, the company identified three material weaknesses in its internal control of financial reporting, all related to inventory accounting.[223] In February 2015, Hanger announced that it would restate financial figures for 2012 through the second quarter of 2014.[224] On November 12, 2015, Hanger disclosed that its audit committee would investigate the circumstances leading to publication of the misstated financials.[225] On February 26, 2016, the com-

212. 15 U.S.C. § 78u-4(b)(2)(A) (2018).
213. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).
214. *Id.* at 193 n.12.
215. VIII Louis Loss et al., Securities Regulation 170 & n.555, 186 (5th ed. 2017).
216. *See infra* notes 219–63 and accompanying text.
217. *See infra* notes 264–95 and accompanying text.
218. *See infra* notes 296–309 and accompanying text.
219. Alaska Elec. Pension Fund v. Asar, No. 17-50162, 2019 WL 1567766, at *1 (5th Cir. Aug. 6, 2018), *superceding withdrawn* 898 F.3d 648 (5th Cir. 2018).
220. *Id.*
221. *Id.* Hanger failed the audits not through fraud but because its clinics failed to "collect the required documentation in a timely manner." *Id.*
222. *Id.*
223. *Id.*
224. *Id.* at *2.
225. *Id.*

pany released preliminary findings from that investigation acknowledging "inappropriate activities" by unnamed employees, and also "that Hanger had overstated its accounts receivable and understated its reserves by approximately $40 million."[226] On May 10, 2016—after several updates about the restatement—Hanger "admitted to overstating its pre-tax income by $87 million."[227] In June 2016, Hanger disclosed "a summary of [its] final investigation results," including (i) "that a former employee had fabricated inventory records"; (ii) that a former CEO and a former CFO "had 'set an inappropriate "tone at the top"' by emphasizing 'achieving certain financial targets,' which 'may have' contributed to inappropriate accounting decisions"; and (iii) that the former CFO and others "had 'engaged in inappropriate historical accounting practices' and that 'particular adjustments . . . were undertaken for the purpose of enhancing [Hanger's] reported financial results.'"[228]

The plaintiff brought a Rule 10b-5 claim against Hanger, the former the CEO and former CFO just mentioned, and the current CEO, alleging fraud (i) by publishing false financial numbers; and (ii) by falsely stating that (a) Hanger was more successful in the Medicare audits and resulting appeals than it was, (b) Hanger's reserves were adequate (when in fact reserves for Medicare claims were not), (c) the Janus implementation was causing only minimal disruption (when in fact introduction of the new system was aggravating difficulties in responding to the Medicare audits), and (d) Hanger's internal controls were adequate (when they were not); and (iii) by understating "'the size and scope of the restatement'" on multiple occasions before the company disclosed the final large number.[229]

The Fifth Circuit affirmed the district court's dismissal of the claim against all defendents on the basis that the plaintiff had failed to plead facts raising a strong inference of scienter.[230] The decision addressed a potpourri of allegations.[231]

First, the court held that the size of the accounting misstatement—$87 million—provided "some basis to infer scienter, but . . . cannot support a strong inference on [its] own" since "'[t]he significance of a large accounting error depends on the circumstances.'"[232] Second, the allegation that the individual defendants sold more of their Hanger stock during the restatement period than before "contribute[d] only slightly to an inference of scienter," given that the Form 4s reporting those sales said that they were made to pay taxes and were pursuant to Rule 10b5-1 plans, and also given that "neither side has pointed to any information about *when* the defendants entered into the 10b5-1 trading plans."[233]

226. *Id.*

227. *Id.*; Third Amended Complaint at para. 2, City of Pontiac Gen. Emps.' Ret. Sys. v. Hanger, Inc., No. A-14-CA-1026-SS, 2017 WL 384072 (W.D. Tex. Jan. 26, 2017), 2016 WL 9080727.

228. *Alaska Elec. Pension Fund*, 2019 WL 1567766, at *2.

229. *Id.* at *1, *2, *10.

230. *Id.* at *1, *11.

231. *Id.* at *3–11.

232. *Id.* at *4 (quoting Owens v. Jastrow, 789 F.3d 529, 541 (5th Cir. 2015)).

233. *Id.* at *4–5. Rule 10b5-1 provides that sales will not be deemed to be "on the basis" of material nonpublic information if made pursuant to a plan—*entered into at a time when an insider did not have material nonpublic information*—that either put the sales on automatic pilot by some protocol predetermining when sales would occur and in what amount, or by transferring sale discretion to an

Third, while the Audit Committee found that the former CEO and the former CFO had "set an 'inappropriate tone at the top' by emphasizing their desire to achieve financial targets," that conclusion did "not strongly support an inference of scienter" because the audit committee gave "no information about *how* they did so."[234] Specifically, there was "no indication that [these two defendants] applied direct pressure to finance personnel. The Audit Committee concludes only that their emphasis on financial targets 'may have' resulted in inappropriate accounting decisions."[235] And the audit committee's finding that "a former lower-level employee orchestrated a large part of the fraud" suggested that Hanger may have largely experienced a "bottom up" fraud rather than a "top down" fraud.[236] Accordingly, the Fifth Circuit found the "tone at the top" described in the Audit Committee investigation contributed only "minimally" to a scienter inference here.[237]

Fourth, although the audit committee concluded that the former CFO was a member of a group "engaged in the improper accounting, and that a subgroup (perhaps as large as the whole group) did so with the requisite scienter" and that he "engaged in inappropriate accounting 'in some instances,'" the audit committee did not specify the "particular inappropriate practices" that the CFO employed.[238] Fifth, the court of appeals discounted the individual defendants' signatures on SOX certifications—saying that they were "responsible for establishing and maintaining internal controls"—as a basis for inferring that the officers knew of the false accounting, relying on precedent holding that an officer's signature on such a certification "'is only probative of scienter if' . . . [the complaint includes] facts establishing that the officer who signed the certification had a 'reason to know, or should have suspected, due to the presence of glaring accounting irregularities or other "red flags," that the financial statements contained material misstatements or omissions.'"[239] Here, "the fact that there were accounting problems does not necessarily mean that the defendants were *aware* of [such] 'red flags.'"[240]

independent party not influenced by the insider and who did not have material nonpublic information when discretion transferred. 17 C.F.R. § 240.10b5-1 (2018).

234. *Alaska Elec. Pension Fund*, 2019 WL 1567766, at *7–8.

235. *Id.* at *8.

236. *Id.* The court added that an emphasis on "'meeting or beating consensus EPS and achieving certain financial targets'" is a goal that "'virtually all corporate insiders share,'" and that Fifth Circuit precedent "has declined to find a strong inference of scienter in [such] goals." *Id.* (quoting *Owens*, 789 F.3d at 539).

237. *Id.* The court, however, added it was "not saying that allegations based on a company's finding of an 'inappropriate tone at the top' can never support a strong inference of scienter." *Id.*

238. *Id.* at *9. The court rejected the notion that "group pleading of scienter" could "adequately address" the former CFO's "individual state of mind," and further reasoned that his scienter could not be "inferred from a conclusion about . . . a subgroup of Hanger employees that might not have included" him. *Id.*

239. *Id.* (quoting Ind. Elec. Workers' Pension Tr. Fund IBEW v. Shaw Grp., Inc., 537 F.3d 527, 545 (5th Cir. 2008) (quoting Garfield v. NDC Health Corp., 466 F.3d 1255, 1266 (11th Cir. 2006))).

240. *Id.*

Sixth and finally, since the allegations against the three individual defendants "contribute[d] only slightly to an inference of scienter, taking them holistically does not allow us to strongly infer scienter as to" them, and "[t]hus, there is no strong inference of scienter that can be imputed to Hanger."[241]

Oddly, a second 2018 opinion—this one by the Third Circuit—also featured both a restatement and an internal investigation critical of the issuer's "tone at the top," and it too ended with a defense victory[242]—as did *Hanger*. On July 16, 2015, Hertz Global Holdings, Inc. ("Hertz") issued a restatement correcting figures previously published for 2011, 2012, and 2013.[243] The "errors stemmed from misstatements relating to fifteen distinct accounting categories, causing Hertz to make twenty separate accounting adjustments to its previous financial statements."[244] The company acknowledged four material weaknesses in its internal control over financial reporting: "control environment, risk assessment, information and communication, and monitoring."[245]

Along the way to the restatement, Hertz conducted two internal investigations.[246] When the company filed the restatement, it said "that 'an inconsistent and sometimes inappropriate tone at the top was present under the then existing senior management' and that the tone 'resulted in an environment which in some instances may have led to inappropriate accounting decisions and the failure to disclose information critical to . . . effective review[.]'"[247]

241. *Id.* at *11.

The text focuses on scienter with respect to the false accounting that the plaintiff charged. The plaintiff also contended that the current CEO, and the former CFO, were liable for false statements about Hanger's performance on Medicare audits, and implementation of the Janus data management system, which allegedly contributed to Hanger's difficulties in responding to the audits. *Id.* at *10. The court also found the scienter allegations respecting these statements wanting. The argument that the CEO and CFO would have known about the Medicare audit performance because they talked about that performance to investors and because Medicare reimbursement was "critically important" to Hanger's business would be appropriate only if special circumstances existed, as was not the case here. *Id.* While a small company might present such a circumstance, "Hanger operated more than 740 clinics 'with over 1,300 clinical practitioners' [and a]lthough Medicare represented 29% of Hanger's sales, that is only slightly larger than the 22.5%" in a previous case in which the Fifth Circuit had rejected the notion that a particular piece of business contributed so large a portion of the company's overall sales that the top executives must have been aware of difficulties with that piece. *Id.* (comparing this case with *Neiman v. Bulmahn*, 854 F.3d 741, 750 (5th Cir. 2017)). While the current CEO and former CFO stated "that they followed the Medicare audits closely, we have held that a CEO's puffery that 'there is nothing in this company that I don't know' could not support a strong inference of scienter." *Id.* (citing *Ind. Elec.*, 537 F.3d at 535). Here the individual defendants "used variations of the phrase 'we are monitoring,' not 'I am monitoring.' These statements could support knowledge of the Medicare problems, but it is equally possible that they merely mean that Hanger as a company monitored the audits." *Id.* While the current CEO and former CFO were aware of problems in Hanger's accounting work, "[k]nowing that the accounting department was having problems is different from knowing what each of those specific problems were." *Id.*

242. *In re* Hertz Glob. Holdings Inc., 905 F.3d 106, 111, 122 (3d Cir. 2018) (affirming dismissal).

243. *Id.* at 112.

244. *Id.*

245. *Id.*

246. *Id.* at 113.

247. *Id.* at 112; *see* Hertz Glob. Holdings Inc., Annual Report (Form 10-K), at iv–vii (July 16, 2015), https://www.sec.gov/Archives/edgar/data/1364479/000136447915000013/hgh2014form10-k.htm [hereinafter Hertz 2014 10-K].

In affirming dismissal of the resulting Rule 10b-5 claim against Hertz and individual executives[248] for the plaintiffs' failure to plead facts raising a strong inference of scienter, the Third Circuit found wanting five sets of allegations.[249] First, the court found that the size of the restatement—correcting a cumulative overstatement of net income by $132 million (20.23 percent) and of pre-tax income by $215 million (17.58 percent)—"provided at most some inference of scienter but not a strong inference" in light of the complaint's failure "to sufficiently allege either that the Individual Defendants knowingly caused Hertz's accounting personnel to engage in accounting fraud or that the accounting improprieties were so obvious that the Individual Defendants must have known about them when reporting Hertz's financial results to the public."[250] Second, the court saw the company's admission of an "inappropriate tone at the top" as "more plausibly interpreted as admissions of mismanagement, not of affirmative misconduct on the part of the Individual Defendants."[251] In explaining this admission, the company said that "'[i]n particular, our former Chief Executive Officer's management style and temperament created a pressurized operating environment at the Company, where challenging targets were set and achieving those targets was a key performance expectation."[252] The Third Circuit found this a reference to "management style and not to misconduct."[253]

Third, top Hertz management's signatures on the Sarbanes-Oxley certifications attached to the periodic filings containing the numbers that had to be restated did not suggest scienter "in the absence of any allegation that [a signing officer] knew he was signing a false SEC filing or recklessly disregarded inaccuracies contained in an SEC filing."[254] Fourth, while Hertz had announced the resignations of its CEO, CFO, and Senior Vice President of Finance and Corporate Controller around the times the company released bad news,[255] "[c]hanges in

248. *Hertz*, 905 F.3d at 111.

249. *Id.* at 116–21.

250. *Id.* at 116.

251. *Id.* at 117.

252. *Id.* (alteration removed and replaced by the language in the Hertz 2014 10-K at v) (quoting appellate brief, in turn quoting the Form 10-K).

253. *Id.*

254. *Id.* at 118. *See* Sarbanes-Oxley Act § 302, 15 U.S.C. § 7241(a)(3) (2018) (requiring that principal executives and financial officers of public companies certify for each quarterly and annual report that, among other things, "based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading" and "the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report"); *see also* resulting regulations at 17 C.F.R. §§ 229.601(b)(31)(i), 240.13a-14(a), 240.15d-14(a) (2018).

255. Hertz made a series of revelations and the resignations occurred within that series. Thus, the CFO resigned "just days" before the company's September 2013 announcement that reduced its projected earnings for that year. *Hertz*, 905 F.3d at 112. The Senior VP for Finance/Controller resigned "[a]bout one month" after the company stated in May 2014 that it would file its 10-K late due to revisions it had to make to previously reported numbers. *Id.* at 112–13. The CEO resigned "several months" after the company's disclosure in June 2014 that it would restate financial numbers for 2011 and correct errors in numbers for 2012 and 2013. *Id.* at 113.

leadership are only to be expected when leadership fails" and are not "in [themselves], a symbol of fraud."[256] Here, "the allegations do not cogently suggest that the resignations resulted from the relevant executives' knowing or reckless involvement in a fraud."[257] Fifth, although the stock sales by the CEO and the Senior VP for Finance/Controller "were unusual when compared to their trading history" and exceeded in each case the executives' yearly salary, the timing of the sales did not suggest knowledge of company fraud because the two "sold their shares when Hertz stock was trading between $21.23 and $28.00, with the vast majority of sales occurring at a price at or below $26.14[, while t]he overall class period high, in contrast, was $31.56 on August 19, 2014."[258] Moreover, the long twenty-nine-month class period weakened "an inference of scienter from insider trading" because "'it is not unusual for insiders to trade at some point during their tenure with a company.'"[259]

Turning from these specific scienter allegations to a "holistic review," the court found a narrative of mismanagement more compelling than a story of fraud: too much pressure from above leading to accounting errors below, which, when discovered, led to the departure of the top executives. Instead of intentional wrongdoing, the "[m]ore plausible . . . suggestion [is] that the Individual Defendants were just bad leaders."[260]

Significance and analysis. Both *Hanger* and *Hertz* rightly declined to infer scienter from an internal report's conclusion that officers set an inappropriate "tone at the top." That phrase is too general to satisfy the statutory standard that an Exchange Act plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with [scienter]."[261]

As did the *Hanger* court in stressing the complaint's failure to show "how" the tone at the top led to accounting errors,[262] so future courts should insist on that factual connection. And when the complaint elaborates the "tone" by converting it into specifics, the court must, as did the *Hertz* court, differentiate between, on the one hand, adjurations (even those deriving from poorly conceived aggressive management[263]) that aim at producing results but end up pushing subordinates to the point that they commit errors, and, on the other hand, directions to record numbers that management knows are false or understands to be recklessly unreliable.

Scienter in additional cases based on accounting restatements. Kohl's Corporation operated more than 1,000 department stores, leasing the property on which 65 percent of those emporiums operated.[264] Kohl's adjusted its accounting for the leases in 2005, 2010, and 2011, with the 2005 and 2011 adjustments

256. *Id.* at 119.
257. *Id.*
258. *Id.* at 120.
259. *Id.* (quoting Yates v. Mun. Mortg. & Equity, LLC, 744 F.3d 874, 891 (4th Cir. 2014)).
260. *Id.* at 121.
261. 15 U.S.C. § 78u-4(b)(2)(A) (2018).
262. *See supra* note 234 and accompanying text.
263. *See supra* notes 252–53, 260 and accompanying text.
264. Pension Tr. Fund for Operating Eng'rs v. Kohl's Corp., 895 F.3d 933, 936 (7th Cir. 2018).

prompting restatements.[265] The 2011 restatement resulted from Kohl's improperly classifying capital leases as operating leases, with the consequence that the leased properties were not recorded as assets and that future rent payments were not recognized as liabilities.[266] A pension fund filed a Rule 10b-5 case against Kohl's, its CEO, and its CFO based on that 2011 restatement.[267] Affirming dismissal,[268] the Seventh Circuit held that the complaint failed to allege adequate facts to support a strong inference of scienter.[269]

The plaintiff defended the complaint on two grounds.[270] First, the pension fund contended that, since Kohl's had encountered problems with its lease accounting twice before, and, because (i) store leases constituted "a core part of its business" and (ii) Kohl's was "aggressively 'renovating and constructing stores,' Kohl's should have known that capital-lease treatment was appropriate earlier on."[271] The Seventh Circuit countered that the adjustments in 2005 and 2010 related to when leases started and ended for accounting purposes, while the "wholly unrelated" question of categorizing leases as operating or capital underlay the 2011 restatement.[272] As to Kohl's categorization of the leases as operating rather than capital despite its "aggressive investment" in its stores, the Seventh Circuit found it "quite possible that Kohl's accountants or external auditors knew they were pushing the boundaries of GAAP to keep leases off the balance sheet, but their knowledge is immaterial to the *scienter* of those making the statements."[273]

Second, the pension fund argued that scienter could be inferred from Kohl's CEO selling 138,000 shares for $7,676,400 in September 2009, and the CFO selling 7,000 shares for $412,000 in September and October 2009 and 2,000 shares for $112,500 in November 2010.[274] But the Seventh Circuit countered that "'because executives sell stock all the time, stock sales must generally be unusual or suspicious to constitute circumstantial evidence of scienter.'"[275] Here the complaint failed to include facts going to whether the pled sales met the "unusual or suspicious" standard, as the pension fund did not allege the percentage

265. *Id.* at 936.
266. *Id.* at 938.
267. *Id.* at 936, 938.
268. *Id.* at 936, 942.
269. *Id.* at 941.
270. *Id.* at 938.
271. *Id.* at 938, 939.
272. *Id.* at 939. While the plaintiff sought to tie the 2010 misaccounting to the 2011 problems by arguing that the 2010 adjustments should have been a part of the 2011 restatement, the court found "no evidence to support" the notion that the defendants had artificially separated the two and that "an innocent explanation is more compelling": that the 2011 problems were discovered after the 2010 adjustments and as a result of a review that Kohl's had to undertake as a condition to obtaining a $1 billion line of credit. *Id.*
273. *Id.* at 940 (citing Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 708–09 (7th Cir. 2008)).
274. *Id.* at 938, 940.
275. *Id.* at 940 (alteration omitted) (quoting Pugh v. Tribune Co., 521 F.3d 686, 695 (7th Cir. 2008)).

of total holdings each executive sold, whether the sales set out in the complaint were atypical for those executives, or "how Kohl's stock price fluctuated around these sales."[276] Moreover, "[t]he most significant insider sales in this case were made in September 2009, 14 months before the 2010 corrections were announced and 23 months before the 2011 corrections were announced"—a temporal separation "more than long enough for any inference of suspicion to dissipate, at least in the absence of concrete facts suggesting otherwise."[277]

Significance and analysis. The court's comment that the issuer's accountants may have known that "they were pushing the boundaries of GAAP to keep leases off the balance sheet, but their knowledge is immaterial to the *scienter* of those making the statements,"[278] follows the Seventh Circuit rule that the scienter of an issuer depends on the scienter of individuals inside the issuer who, with authorization, make or approve the statements on which the issuer is sued.[279] *Kohl's* raises the question of who—if not the accountants—that might be, when the allegedly false statements are contained within the issuer's published financial figures.

In a second case revolving around an accounting error, the issuer left out one of the numbers in the denominator of a ratio used to allocate overhead expenses between its sales and lease operations, with the result that—for seven quarters, beginning in the first quarter of 2012, the year the issuer conducted its initial public offering—the company's financials understated the overhead allocated to sales.[280] As a result, "while [the issuer, company-wide] reported gross sales margins of −19% in 2010 and −14% in 2011, beginning in Q1 2012, the company's sales margin jumped, and it reported a gross sales margin of +21% in 2012."[281] Suing the issuer, a co-founder and CEO, and the CFO, an investor brought a Rule 10b-5 claim on behalf of all who bought the company's stock from December 12, 2012 to March 18, 2014.[282]

The Ninth Circuit found the scienter allegations insufficient and accordingly affirmed the district court's dismissal.[283] The complaint included information from eleven confidential witnesses who described the issuer's ("Solarcity") disorganized, short-handed accounting staff and the individual defendants' knowl-

276. *Id.*

277. *Id.* After rejecting the two particular arguments the pension fund advanced to support its scienter pleading, the Seventh Circuit found that a holistic review of the allegations would not save the complaint because "[e]ach allegation in the complaint is advanced without any sense of how the dots connect." *Id.*

278. *See supra* note 273 and accompanying text.

279. *Id.* Analytically, this may be a different question from which individuals inside the company could be properly named as individual defendants under *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011). *See infra* notes 306–09 and accompanying text.

280. Webb v. Solarcity Corp., 884 F.3d 844, 847–48 (9th Cir. 2018).

281. *Id.* at 848. While the plaintiff focused on how the error affected the financial performance of the sales operations, the "error also affected the [entire] company's reported net income and earnings per share, which led the company to materially understate net loss and report higher earnings per share." *Id.*

282. *Id.* at 846–47.

283. *Id.* at 846, 858.

edge of negative sales margins and the company's accounting.[284] The plaintiff argued that the defendants had a motive to lie as the "sales-division-profitability turnaround was critical to the company's successful IPO" because that "division's performance was an obvious vulnerability; though it generated the majority of Solarcity's annual revenues, the sales division had run losses" in each of the two years before the offering.[285] More personally, the complaint alleged that one of the individual defendants owned 4,160,711 shares of company stock and the other owned 96,840—and "were [therefore] incentivized to maintain the company's stock price."[286] Finally, the plaintiff contended that the turnaround in the sales operations performance worked by the defective ratio—"a sudden . . . increase of over 100% in gross margins for solar energy sales in fiscal year 2012"—"was so dramatic that it would be absurd to think that Defendants-Appellees did not know about the burden-ratio change during the Class Period," an argument based on the "core operations" inference.[287]

The Ninth Circuit found none of this sufficient, even when "[c]onsidered holistically."[288] At most, these allegations "paint a picture of a mismanaged organization in need of closer financial oversight that made a minute error at a critical stage in its development."[289] Balanced against (i) the individual defendants' knowledge of unprofitable operations, (ii) their "reason[s] to suspect that the company's internal accounting controls were imperfect," and (iii) the "strong incentive to . . . keep stock prices high in the months immediately preceding and following" the IPO were the facts that (a) neither of the individual defendants sold any of their stock during the period of the alleged fraud; and (b) both were—by the confidential witnesses' own reports—"forthcoming with their employees, admitting at company meetings that the sales division and the company as a whole were not profitable"; moreover, (c) even with the accounting error, the company "showed in its Prospectus for the IPO that [the company overall] was not profitable."[290] As to the plaintiff's "core operations" theory, the court

284. *Id.* at 851–54. As examples, one confidential witness described "the company's accounting and financials [as] 'a mess,'" while another said that the company "'hadn't closed the books in a year.'" *Id.* at 851–52. One offered that the CFO "'was involved in financial and accounting policy decisions at [the company,]'" and another believed that both the co-founders (including the one sued) "were 'intimately involved in the Company in all aspects'" and "'totally would have been aware of' any decision to change the company's accounting method for overhead costs." *Id.* at 852–53. One said that "the company's 'sales segment often showed negative margins'" and believed that the defendant co-founder knew this, while another reported that "[t]he sales projects' negative margins were discussed in 'a number of conference calls' in which [the confidential witness], the [two co-founders], and sometimes [the CFO] participated." *Id.* at 852.

285. *Id.* at 854.

286. *Id.*

287. *Id.* at 855. The "core operations" inference posits that "facts critical to a business's 'core operations' or an important transaction are known to a company's key officers." South Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 783 (9th Cir. 2008).

288. *Solarcity*, 884 F.3d at 855.

289. *Id.* at 856.

290. *Id.* Elon Musk had invested in the issuer. *Id.* at 847. He had used his shares as collateral for loans from Goldman Sachs, which would generate margin calls if the value of the pledged shares fell. *Id.* at 854. The plaintiff suggested that the defendants sought to pump the price of the stock to help Musk avoid this

pointed out that the sales division was only "a relatively minor portion of the company's overall business."[291] And the error in the overhead allocation ratio "was so subtle that it appears that even the company's specialized accounting division and professional auditors missed it."[292] Finally, the court hinted that the change in the sales division's gross margins from −14 percent in 2011 (when the ratio was correct) to −5 percent in 2012 (when it was incorrect) did not stand out because the company as a whole was losing money.[293]

Significance and analysis. *Solarcity* joins other cases in which defendants facing Rule 10b-5 allegations resting on restated financial figures have successfully argued that the very disorganization to which the plaintiff points shows that the defendants had no scienter.[294] Thus, *Tellabs*' invitation to counter a plaintiff's narrative with one of the defendant's own making has encouraged,[295] oddly, the defense that the defendants were such poor managers that they could not have intended to commit fraud but simply stumbled into accounting errors.

Scienter of corporation. In an opinion not published in the Federal Reporter, the Second Circuit commented on the scienter of corporations. The decision affirmed dismissal of a complaint against a bank for allegedly violating Rule 10b-5 by misrepresenting the effectiveness of its anti-money laundering controls while the plaintiff class bought the bank's securities between January 13, 2013, and July 26, 2016.[296] Under the circuit's protocols, "'[t]he requisite scienter can be established by alleging facts to show either (1) that defendants had the motive and opportunity to commit fraud, or (2) strong circumstantial evidence of conscious misbehavior or recklessness.'"[297] The complaint named as defendants the bank and "several of its corporate officers."[298]

As to the first possibility, the "[p]laintiffs . . . failed to show motive and opportunity to commit fraud because they have not adequately alleged that *the individual defendants* received a 'concrete and personal benefit' from making their

fate. *Id.* But the complaint included no facts to "support an inference that [the defendants] were at all interested in or concerned for Musk's relationship with Goldman Sachs." *Id.* at 856–57.

291. *Id.* at 857. The court did not attempt to square this characterization with its earlier statement that the sales division generated most of the company's revenues. *See supra* note 285 and accompanying text.

292. *Id.*

293. *Id.* at 858. The Ninth Circuit remarked, finally, that while the "allegations regarding [the individual defendants'] hands-on approach to management are relevant," "[i]ndependently . . . they are not strong enough to create an inference of involvement sufficient to satisfy" the special statutory scienter pleading requirement. *Id.*

294. *See, e.g.*, *In re* Magnum Hunter Res. Corp. Sec. Litig., 616 F. App'x 442, 446 (2d Cir. 2015).

295. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 326 (2007) ("[T]he court's job is not to scrutinize each allegation in isolation but to assess all the allegations holistically.").

296. Sfiraiala v. Deutsche Bank Aktiengesellschaft, 729 F. App'x 55, 56–58 (2d Cir. 2018) (describing, at page 58, the misrepresentations generally as concerning "internal controls"); *id.* at 59 (stating specifically that "anti-money laundering controls" were the "subject matter of the alleged misrepresentations").

297. *Id.* at 57 (quoting ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 198 (2d Cir. 2009)).

298. *Id.* at 56.

alleged misrepresentations."[299] As to the second possibility, the court pointed to the rule that "'[w]hen the defendant is a corporate entity, . . . the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter.'"[300] Since the "[p]laintiffs here [did] not argue that the individual defendants knowingly made the alleged misrepresentations," they were left to plead that the defendants "recklessly disregarded facts showing that their representations concerning Deutsche Bank's internal controls were inadequate."[301]

None of the allegations showed that the individual defendants had displayed such recklessness. While the plaintiffs pointed to a consent order between the bank and the New York Department of Financial Services that specifically chastised the bank for "'serious compliance deficiencies' . . . [that] allowed a group of Moscow-based 'bank traders and offshore entities to improperly and covertly transfer more than $10 billion out of Russia,'" that report also said "that 'no concerns relevant to the suspicious trading activities were ever escalated out of Moscow'" until March 2015, at which time the bank initiated an internal investigation.[302] Although the plaintiffs also pointed to "regulatory reports from the Federal Reserve," those "reports largely do not concern . . . anti-money laundering controls."[303] The plaintiffs' reference to an October 11, 2005 agreement by which the bank promised the Federal Reserve and the New York State Banking Department to improve its anti-money laundering controls did not avail because there was "no indication in the record that [the bank] failed to follow through with its obligations" to do so.[304] Lastly, fines and government enforcement actions against the bank in 2015—although specifically revolving around money-laundering—did not "establish . . . that any of the individual defendants were aware of these deficiencies at the time of their alleged misrepresentations, or that the deficiencies were 'so obvious' that the individual defendants 'must have been aware' of them."[305]

Significance and analysis. The federal appellate courts have yet to address whether, and if so how, *Janus Capital Group, Inc. v. First Derivative Traders* affects the analysis of corporate scienter.[306] *Janus* holds that, in a case brought under Rule 10b-5(b) and therefore premised on a statement that is either false or mis-

299. *Id.* at 57 (emphasis added) (quoting Kalnit v. Eichler, 264 F.3d 131, 139 (2d Cir. 2001)).

300. *Id.* at 58 (quoting Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc., 531 F.3d 190, 195 (2d Cir. 2008)). The court added: "*Teamsters* recognized that '[i]t is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud[,]'" [531 F.3d at 195, but w]e have not since elaborated on when this is the case, and plaintiffs have failed to allege facts supporting an inference of scienter on this ground regardless of the relevant standard." *Sfiraiala*, 729 F. App'x at 58 n.1.

301. *Id.*

302. *Id.* The class period during which the alleged fraud occurred ran from January 31, 2013, to July 26, 2016. *Id.* at 56.

303. *Id.* at 59.

304. *Id.*

305. *Id.* (quoting, in the last instance, from S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 109 (2d Cir. 2009)).

306. 564 U.S. 135 (2011).

leading because it omits a material fact, the proper defendant is "the person or entity with ultimate authority over the statement."[307] More than one defendant can possess that authority over a given statement.[308] One possible rule would limit the knowledge imputed to a corporation for scienter analysis—for any given statement—to the individuals within the company who had *Janus*-adequate control over the challenged statement. Another possible rule might cast the knowledge net more broadly, to include anyone who contributed to a statement or reviewed it, even if he or she did not possess ultimate control over content and dissemination. The formula provided by the Second Circuit—that the scienter must find its locus in "someone whose intent could be imputed to the corporation" and who "acted with the requisite scienter"[309]—is too vague to discriminate between these possibilities because it fails to identify how the relevant individual "acted" with respect to statements underlying the claim.

Coincidence of knowledge and duty to disclose when defendants are part of a business group. Investors that purchased Enron debt sued a collection of entities for violation of Rule 10b-5, including UBS Financial Services, Inc. (formerly UBS PaineWebber, Inc.) ("PaineWebber"), UBS Securities LLC (formerly UBS Warburg, LLC) ("Warburg"), and UBS AG.[310] Each one of these was a "distinct corporate entit[y]," but affiliated because PaineWebber and Warburg "are, or were at the relevant times, subsidiaries of UBS AG."[311] Considered "[t]ogether they constitute 'UBS,' one of the largest banks in the world."[312]

The plaintiffs bought the debt through PaineWebber.[313] They alleged that, considered collectively, the defendants "knew of Enron's financial manipulations and impending demise[while] . . . ow[ing] Plaintiffs a duty to disclose such knowledge," but failed to perform that duty.[314] Affirming dismissal of the claim,[315] the Fifth Circuit rejected the theory that the defendants could be treated "as if they were a single entity."[316] The court then proceeded to find none of the defendant entities had *both* the knowledge of Enron's financial circumstances and a duty to disclose to the plaintiffs.

307. *Id.* at 142.

308. *See* Glickenhaus & Co. v. Household Int'l, Inc., 787 F.3d 408, 427 (7th Cir. 2015) ("Nothing in *Janus* precludes a single statement from having multiple makers.").

309. *See supra* note 300 and accompanying text.

310. Giancarlo v. UBS Fin. Servs., Inc., 725 F. App'x 278, 280–81 (5th Cir. 2018), *cert. denied*, 139 S. Ct. 199 (2018) (mem.).

311. *Id.* at 280 & n.1.

312. *Id.* at 280.

313. *Id.*

314. *Id.*

315. *Id.* at 280, 289.

316. *Id.* at 283–84. In this respect, the plaintiffs contended that all three entity defendants formed a "de facto joint venture" under Delaware law so that "we can attribute each defendant's actions and knowledge to a single entity called 'UBS.'" *Id.* at 283. But though the plaintiffs set out the elements of a de facto joint venture, they failed to plead those elements here; for example, "[n]one of the allegations allude to profit sharing, or loss sharing." *Id.* Instead, they relied "principally" on "Defendants' vague corporate platitudes about their integration as a firm," which "may logically support that Defendants shared a community of interest in their business activities, but . . . alone is insufficient to support joint venture liability." *Id.* at 284.

Noting that "a searching review of the relevant documents supports, at most, that Warburg and UBS AG had some insider knowledge of Enron's financial situation, as those are the defendants that participated in the transactions identified by Plaintiffs," the court of appeals concluded that the plaintiffs had to plead that *those defendants*—the ones with the material information—"owed them a duty of disclosure."[317] While the plaintiffs pointed to a National Association of Securities Dealers rule requiring fair communications with the public, the plaintiffs only alleged communicating with PaineWebber and plaintiffs failed to "sufficiently allege[] that any person at PaineWebber had knowledge concerning Enron's financial manipulations."[318] While the plaintiffs alleged that UBS AG and Warburg were market-makers for Enron securities, the plaintiffs failed to plead that either of those two defendants sold the plaintiffs securities.[319] And, although the plaintiffs alleged that "their brokers were employees of PaineWebber," they did not argue "that PaineWebber had any special knowledge of the market for Enron debt securities, and UBS AG's and Warburg's dealings with Enron cannot support that PaineWebber had a duty of disclosure."[320] In short, none of the entities had *both* the omitted facts and the duty to disclose them.

Significance and analysis. Although addressing the element of duty to disclose in an omissions case, the Fifth Circuit decision in *UBS* resembles that circuit's treatment of corporate scienter. In its *Southland Securities Corp. v. INSpire Insurance Solutions* opinion in 2004, that court of appeals held that a Rule 10b-5 claim against a corporation must rest, for the scienter element, on "the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment."[321] If the collective knowledge inside a single corporation cannot be automatically imputed to an employee authorized to speak for the firm, still less should the knowledge of a distinct but affiliated company be imputed to a defendant entity accused of improperly withholding that knowledge while under a duty to disclose.

Rebutting the fraud-on-the-market presumption. To certify a Rule 23(b)(3) class in a securities lawsuit, the district court must "find[] that the questions of law or fact common to class members predominate over any questions affecting only individual members."[322] Reliance is an essential element of a private Rule 10b-5 claim.[323] If class members must prove individually that they relied

317. *Id.* at 284.
318. *Id.* at 285.
319. *Id.* at 286.
320. *Id.*
321. 365 F.3d 353, 366 (5th Cir. 2004).
322. Fed. R. Civ. P. 23(b)(3).
323. Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 267 (2014).

on defendants' misrepresentations, a court cannot find that common questions predominate and therefore cannot certify a Rule 23(b)(3) class.[324] To avoid this result, class plaintiffs employ the FOTM presumption that, where the relevant security trades in an efficient market, the price of the security impounds misstatements that the defendants disseminate so that all buyers and sellers rely on misrepresentations indirectly by purchasing or selling at prices the falsehoods affect.[325]

Where defendants contest application of this theory, proof on class certification proceeds in the following order. First, the plaintiff must show that the market for the relevant security is generally efficient.[326] Then the defendants have an opportunity to show that, regardless of whether that market is *generally* efficient, it did not reflect the particular alleged misinformation in the relevant security's price—i.e., that the alleged misrepresentations had no "price impact."[327] In 2017, the Second Circuit held that, when the defendants attempt to defeat certification by rebutting the FOTM presumption in this way, defendants must prove an absence of price impact by "a preponderance of the evidence."[328]

In 2018, the Second Circuit applied these protocols in *Arkansas Teachers Retirement System v. Goldman Sachs Group, Inc*.[329] Plaintiffs brought a Rule 10b-5 case on behalf of those who purchased shares of Goldman Sachs ("Goldman") between February 5, 2007, and June 10, 2010.[330] They charged that, during that period, Goldman falsely represented that it adequately controlled conflicts of interest in the transactions it created[331] while, in fact, it permitted an investor taking the short position in one synthetic CDO to select particularly risky assets as the reference securities and that, in three other CDO transactions, Goldman represented to investors that it contributed equity to the deals without disclosing that it simultaneously held short positions.[332] While the plaintiffs had not invested in any of these CDOs, they alleged loss because, when the SEC sued Goldman on the first deal and when the press reported that the SEC was investigating Goldman on the others, the price of Goldman's shares declined; from which the

324. *Id.* at 268.

325. *Id.*

326. *Id.* at 279.

327. *Id.* at 279–81.

328. Waggoner v. Barclays PLC, 875 F.3d 79, 101–02 (2d Cir. 2017), *cert. denied*, 138 S. Ct. 1702 (2018) (mem.).

329. 879 F.3d 474 (2d Cir. 2018).

330. *Id.* at 478.

331. *Id.* For example, Goldman said:

> Our reputation is one of our most important assets. As we have expanded the scope of our business and our client base, we increasingly have to address potential conflicts of interest, including situations where our services to a particular client or our own proprietary investments or other interests conflict, or are perceived to conflict, with the interest of another client . . . .

Id.

332. *Id.* at 479; *see* Complaint, SEC v. Goldman, Sachs & Co., No. 10-CV-3229 (S.D.N.Y. Apr. 16, 2010), https://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf.

plaintiffs inferred that the assurance of conflict-control practices had artificially inflated the share price for years.[333]

On the class certification motion, the defendants "presented evidence in the form of declarations and sworn affidavits that Goldman stock experienced no price increase on the dates the [challenged] statements were made, and no price decrease on 34 occasions before 2010 when the press reported Goldman's conflicts of interest in the [four CDO] transactions" around which the plaintiffs built their case.[334]

After the district court granted the motion to certify, the defendants obtained appellate review under Rule 23(f).[335] The Second Circuit vacated the certification because it was "unclear whether the District Court applied the correct standard"—which the Second Circuit had announced in the 2017 case that the court of appeals published after the district court's class ruling.[336] The court of appeals criticized the lower court in two respects.

First, the district court—which granted the certification without either an evidentiary hearing or oral argument[337]—had characterized the defense submissions as (i) making a "truth on the market" argument or (ii) a materiality argument, both of which were inappropriate on a class certification motion.[338] The court of appeals demurred, on the rationale that a "truth on the market" defense contends that the market was already aware of the truth behind a falsehood when the plaintiffs purchased, with the market therefore having already impounded the truth into the security's price when the plaintiffs bought.[339] The defense argument here was different—that the market did not react when the alleged truth came out, and therefore "that their statements about Goldman's efforts to avoid conflicts of interest 'did not actually affect the stock's market price'" at all.[340] As to materiality, while "price impact touches on materiality," an element that is not relevant to class certification,[341] price impact is also relevant to reliance, particularly where the plaintiffs seek to establish reliance through the FOTM presumption.[342]

Second, the district court held that, even if it had considered the defense evidence in spite of what that court took to be its misguided purpose, the evidence did not rebut the market-reliance presumption because it was "'not . . . conclu-

333. *Goldman*, 879 F.3d at 479. The price of Goldman shares declined by 13 percent after the SEC filed the lawsuit cited in the previous note. *Id.*

334. *Id.* at 481.

335. *Id.* at 482.

336. *Id.* at 484 (*Waggoner* was decided "[a]fter the District Court granted plaintiffs' motion for class certification"); *id.* at 486 (vacating on the rationale quoted in the text).

337. *Id.* at 482.

338. *Id.*

339. *Id.* at 485.

340. *Id.* at 486 (quoting Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 282 (2014)).

341. *Id.* at 481 n.6 (citing Amgen Inc. v. Conn. Ret. Plans & Tr. Funds, 568 U.S. 455, 466–67 (2013), for the proposition that "[a]lthough materiality is 'an essential predicate of the fraud-on-the-market theory,' it is common to the class and does not bear on the predominance requirement of Rule 23(b)(3)").

342. *Id.* at 486.

sive evidence that no link exists between the price decline [of Goldman stock] and the misrepresentation[s].'"[343] The court of appeals reaffirmed its 2017 standard that the defense need only show an absence of price impact by a preponderance of the evidence and that, if the lower court imposed a heavier burden through its reference to "conclusive[]" proof (which the Second Circuit allowed was "unclear"), that standard was too high.[344]

Significance and analysis. In sending the case back to the lower court, the Second Circuit expressed "no views as to whether the evidence is sufficient to rebut the [FOTM] presumption."[345] But it did "encourage the [district] court to hold any evidentiary hearing or oral argument it deems appropriate" in "further proceedings consistent with th[e court of appeals'] opinion."[346] Thus, while the Second Circuit's 2017 decision requiring defendants rebutting the presumption to show an absence of price impact by a "preponderance of the evidence" sets a high hurdle, the *Goldman* case unmistakably announces that the court of appeals was not intending to discourage the tendency of class certification motions to morph into full-blown merits hearings on an essential element of private Rule 10b-5 claims. Since, as the court acknowledges, virtually the same arguments that affect reliance in an FOTM case also affect other elements such as materiality, the class certification motion becomes—after motions to dismiss—the second key stop in many cases, after which the plaintiffs may lose or the defendents may wish to settle.

Loss causation. To win Rule 10b-5 damages, a plaintiff must establish loss causation.[347] In an open-market case, a plaintiff can do so by alleging and proving that the price of a company's stock declined after a corrective disclosure revealed the truth behind a falsehood or gave the market the material information that the defendant had a duty to disclose but did not.[348] The Ninth Circuit held last year that a plaintiff adequately pleads loss causation by showing a decline in stock price following disclosure of the facts that defendants misrepresented or omitted, even if the disclosure does not also reveal that the misrepresentation or omission resulted from fraud.[349] The Eighth Circuit held that a plaintiff failed to allege loss causation where the stock redemption upon which she based her case was required by contract and did not result from the alleged fraud.[350] The Fifth Circuit affirmed dismissal on the ground that the complaint alleged loss caused by the issuer's underlying wrongdoing rather than by any false statements

343. *Id.* at 482 (quoting *In re* Goldman Sachs Grp., Inc. Sec. Litig., Master File No. 10 Civ. 3461 (PAC), 2015 WL 5613150, at *7 (S.D.N.Y. Sept. 24, 2015)).

344. *Id.* at 485.

345. *Id.* at 486.

346. *Id.*

347. 15 U.S.C. § 78u-4(b)(4) (2018).

348. *See* Dura Pharms. Inc. v. Broudo, 544 U.S. 336, 344 (2005) ("[T]he Restatement of Torts, in setting forth the judicial consensus, says that a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains 'when the facts . . . become generally known' and 'as a result' share value 'depreciate[s].' § 548A, Comment b, at 107.").

349. *See infra* notes 354–61 and accompanying text.

350. *See infra* notes 362–73 and accompanying text.

or omissions about that wrongdoing.[351] The Second Circuit ruled that a complaint adequately alleged loss causation even though a trading halt delayed the effect of a corrective disclosure.[352] In a case where the plaintiffs alleged a medical device company encouraged physicians to use inappropriate coding to obtain reimbursement while falsely telling investors that the company was advising doctors to use correct coding, the Fourth Circuit concluded that allegations of a more than 40 percent stock price drop following the issuer's announcement that it had received a government subpoena sufficed to plead loss causation where an analyst report connected the subpoena with the half of the issuer's revenue generated by procedures physicians coded incorrectly.[353]

Corrective disclosure revealing truth but not fraud. The Ninth Circuit addressed last year in *Mineworkers' Pension Scheme v. First Solar Inc.* whether, in order to constitute a corrective disclosure, a revelation must show that the defendants acted fraudulently.[354] Investors asserted a Rule 10b-5 claim, alleging that a company producing solar panel modules, and its officers, fraudulently concealed product defects, misrepresented the cost and scope of the defects, and published false financial numbers.[355] After granting a defense motion for summary judgment in part and denying it in larger part, the district court certified the following question to the court of appeals under 28 U.S.C. § 1292(b): "Can a plaintiff prove loss causation by showing that the very facts misrepresented or omitted by the defendant were a substantial factor in causing the plaintiff's economic loss, even if the fraud itself was not revealed to the market, or must the market actually learn that the defendant engaged in fraud and react to the fraud itself?"[356]

The Ninth Circuit responded by holding that the test is proximate cause—with "plaintiffs need[ing] only [to] show a 'causal connection' between the fraud and the loss by tracing the loss back to 'the very facts about which the defendant lied.'"[357] Accordingly, "[r]evelation of fraud in the marketplace is simply one of the 'infinite variety' of causation theories a plaintiff might allege to satisfy proximate cause," but "[a] plaintiff may also prove loss causation by showing that the stock price fell upon the revelation of an earnings miss, even if the market was unaware at the time that fraud had concealed the miss."[358] In this case, "[s]teep declines in [the defendant issuer's] stock, beginning on July 29, 2010, followed the release of quarterly financial disclosures reporting the defects and associated costs, the departure of [the company's] CEO, and disappointing

351. *See infra* notes 374–87 and accompanying text.
352. *See infra* notes 388–97 and accompanying text.
353. *See infra* notes 398–426 and accompanying text.
354. 881 F.3d 750 (9th Cir. 2018), *petition for cert. filed*, No. 18-164 (2018).
355. *Id.* at 752.
356. *Id.* at 752, 753 (citations omitted).
357. *Id.* (quoting, in the first instance, Nuveen Mun. High Income Opportunity Fund v. City of Alameda, 730 F.3d 1111, 1119 (9th Cir. 2013); then quoting, in the second, *Nuveen*, 730 F.3d at 1120).
358. *Id.* at 754 (quoting Lloyd v. CVB Fin. Corp., 811 F.3d 1200, 1210 (9th Cir. 2016)). The Ninth Circuit added: "That a stock price drop comes immediately after the revelation of fraud can help to rule out alternative causes. But that sequence is not a condition of loss causation." *Id.* (citation omitted).

financial results."[359] The district court had found "the evidence, if accepted by the jury, could satisfy the proximate cause loss causation test with respect to five of the six alleged stock price declines."[360] The court of appeals concluded that the lower court had correctly tested the proffered evidence to determine whether "the very facts misrepresented or omitted by the defendant were a substantial factor in causing the plaintiff's economic loss, even if the fraud itself was not revealed to the market," and that the market need not necessarily "learn that the defendant engaged in fraud and react to the fraud itself."[361]

Securities sale required by contract. While open market cases featuring dueling experts dominate the loss causation decisions in the Federal Reporter, 2018 produced a private company case that focused on deal documents. The plaintiff owned stock in a family company.[362] She signed stock redemption agreements in 1989 and 2003.[363] The company sent the plaintiff a third revised redemption agreement (the "RRA")—which would govern going forward—in December 2007, and the plaintiff signed that agreement in November 2008.[364] The RRA provided that "[the company] 'shall have the right to repurchase the stock, in whole or in part, owned by Stockholder at any time'"; and "the stock 'shall be purchased at the fair market value of the stock (subject to any applicable discounts or adjustments) as set forth in the most recent valuation prepared by Juris Valuation Advisors [JVA] . . . immediately preceding the date of the written notification of the option exercised by . . . the Corporation.'"[365]

In June 2012, the company notified the plaintiff that it was exercising its right to redeem her shares for $9,280,235 and sent her a stock purchase agreement (the "SPA") to sign in connection with that redemption.[366] The company computed the payment by applying an October 2011 JVA valuation.[367] When the plaintiff failed to sign, the company wired payment to the plaintiff and advised her that she no longer owned the stock; and when the plaintiff sent the money back, the company said that it would treat the money as unclaimed property under Nebraska state law.[368] Eventually, the plaintiff signed the SPA on August 22, 2012, after crossing out the mutual release, a change to which the company agreed.[369]

The plaintiff brought this case to recover under a bevy of state claims, as well as under Rule 10b-5.[370] In affirming dismissal of that latter claim, the Eighth Circuit agreed with the district court's conclusion that the plaintiff "did not plausibly plead loss causation because the Complaint alleged that the RRA gave [the com-

359. *Id.* at 752.
360. *Id.* at 754.
361. *Id.* at 753 (quoting the district court's certified question).
362. Ryan v. Ryan, 889 F.3d 499, 502–03 (8th Cir. 2018).
363. *Id.*
364. *Id.* at 503; Complaint at para. 27, Ryan v. Ryan, No. 8:15-cv-00312, 2016 WL 9175626 (D. Neb. Feb. 18, 2016).
365. *Ryan*, 889 F.3d at 503 (second ellipsis added).
366. *Id.*
367. *Id.* at 504.
368. *Id.* at 503.
369. *Id.*
370. *Id.* at 502.

pany] the right to purchase her stock at its election."[371] Regardless of what the defendants had done, the plaintiff was therefore "obligated" to sell her stock back to the company "when [the company] exercised its right to repurchase under Paragraph 7 of the RRA."[372] Since she labored under this obligation to sell, her sale could not have been "caused" by "[d]efendants' alleged misconduct."[373]

Loss from wrongdoing versus loss from false or misleading statements. It can be difficult at times to separate the damage caused by underlying wrongdoing and the damages caused by alleged misstatements about the wrongdoing. In *Employees' Retirement System v. Whole Foods Market, Inc.*, the Fifth Circuit sought to untangle just such a causal knot.[374]

Whole Foods violated weights and measures laws by charging weight-based prices that included the weight of packaging as well as the food inside.[375] Both California and New York City regulators (with the NYC Department of Consumer Affairs ("DCA") issuing "a scathing report") fined the company, which then caused the company to make a well-publicized apology, to miss its third-quarter 2015 sales targets after a "marked slowdown in sales growth in the two weeks between the DCA's report and the end of the quarter," and to "attribute[] the decline to the DCA findings and the negative press that it attracted."[376] Whole Foods shareholders sued the company and selected officers under Rule 10b-5, claiming that the defendants misled the market by "(1) statements touting Whole Foods' price competitiveness or efforts to increase its price competitiveness; (2) statements about Whole Foods' commitment to transparency, quality, and corporate responsibility; and (3) statements announcing Whole Foods' allegedly inflated revenues."[377]

The court of appeals affirmed dismissal[378] insofar as the claim rested on the first category because the challenged statements simply said that the company provided competitive pricing to retail customers or was working to improve its pricing.[379] While the plaintiffs argued "that because Whole Foods' effective

371. *Id.* at 506.

372. *Id.* at 507.

373. *Id.* The court of appeals noted specifically that the plaintiff did not allege that the defendants had manipulated the October 2011 JVA valuation. *Id.* at 506.

The absence of loss causation also doomed the plaintiff's claims under state securities law and for fraud, breach of fiduciary duty, and shareholder oppression. *Id.* at 507.

The court of appeals, however, reversed and remanded for the district court to revisit the plaintiff's request to amend the complaint to allege that JVA had revalued the stock upwards in a July 27, 2012 report. *Id.* at 509–10. The Eighth Circuit suggested that this might save the plaintiff's breach of contract claim, if she could demonstrate that the redemption's effective date fell after the revaluation and therefore should have been priced at its higher number. *Id.*

374. 905 F.3d 892 (5th Cir. 2018).

375. *Id.* at 894–95.

376. *Id.* at 894–96.

377. *Id.* at 900.

378. *Id.* at 894, 905.

379. *Id.* at 896, 900–01. For example, one of the two Whole Foods CEOs stated on a conference call in February 2014: "Our internal pricing surveys showed improvements from Q4 to Q1, in a competitive price positioning across virtually all competitors in all areas . . . ." *Id.* at 896. As another example, that same co-CEO stated in a February 2015 conference call: "We continue to see unit lift

prices were revealed to be higher than advertised, the defendants must have lied when they characterized Whole Foods' prices as 'competitive,'" the court responded that "just because Whole Foods' prices were not *as* competitive as advertised, it need not follow that they were not competitive."[380] The Fifth Circuit affirmed dismissal of the claim insofar as it rested on the second category because the challenged statements about Whole Foods' transparency, quality, and corporate responsibility[381] constituted general self-congratulation of the sort "that a reasonable investor would not rely on."[382]

Turning to the third category of alleged misstatements—financial statements that the plaintiffs contended had been "exaggerated . . . by counting towards its revenues receipts that Whole Foods fraudulently collected by overcharging customers"—the court of appeals "assum[ed] arguendo that the plaintiffs allege falsity . . . with particularity," but affirmed dismissal insofar as the case rested on the financial results because "plaintiffs do not allege that Whole Foods' inflated revenues caused the plaintiffs' loss."[383] As the Fifth Circuit analyzed it, the plaintiffs contended that Whole Foods' weights and measures violations, and the associated negative publicity, caused a sales decline that in turn reduced sales so much that the company missed its sales projections, with that miss then causing a decline in Whole Foods' stock price.[384] "But the accounting problems did not cause the public-relations problem, nor [did] the plaintiffs allege that the accounting problems caused a separate loss in stock price."[385]

Significance and analysis. Whole Foods never restated financials.[386] The easier analysis would have pointed to this fact, observing that since the financial numbers were never corrected, the market could not have reacted to falsity of those numbers. Indeed, the market seemed to have reacted to the revenue figures on the assumption that they were true and that they accurately showed that sales failed to meet projections.[387]

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from the lower produce pricing we are testing in several markets. . . . [W]e believe more competitive produce pricing will greatly benefit our overall value perception." *Id.* at 896–97.

380. *Id.* at 901.

381. *Id.* at 897. For example, the company included in a November 2013 Form 10-K the statement that "Whole Foods 'seek[s] to be a deeply responsible company in the communities where [it] do[es] business around the world, providing ethically sourced, high-quality products and transparent information to [its] customers.'" *Id.* As another example, the company included in a statement to customers following the settlement with the California state regulators the assurance that "it 'always strive[s] for transparency and accuracy in everything [it] do[es]' and it 'take[s] pride in setting higher standards for quality.'" *Id.*

382. *Id.* at 902 (adding that although "it matters to investors whether Whole Foods is transparent and otherwise holds itself to high standards," "reasonable investors will not simply take Whole Foods' word for it").

383. *Id.* at 902–03.

384. *Id.* at 904.

385. *Id.* (adding: "The plaintiffs' apparent error is that they conflate the nonactionable weights-and-measures fraud with the allegedly actionable securities fraud.").

386. Brief of Defendants-Appellees at 12, Emps.' Ret. Sys. v. Whole Foods Mkt., Inc., 905 F.3d 892 (5th Cir. 2018) (No. 17-50840), 2018 WL 454121.

387. For this same reason, the plaintiffs could not prevail on a realization of risk theory. The plaintiffs did not contend that the third-quarter revenue figure was unexpectedly low because Whole Foods had removed the asserted inflation caused by overcharges but contended instead

Delayed effect of corrective disclosure where trading halted. The Second Circuit considered last year whether a delayed effect on stock price could demonstrate loss causation.[388] The plaintiffs sued on behalf of a class that purchased 6D Global Technologies ("6D") stock from June 16, 2014, to September 10, 2015, and who bought stock in a private 6D placement in September–November 2014.[389] They alleged that 6D failed to disclose that Benjamin Wey—"an indicted fraudulent manipulator of securities"—exercised control over New York Global Group ("NYGG-Asia") that beneficially owned 45 percent of 6D's outstanding stock,[390] and that 6D's CEO and CFO—"despite privately acknowledging Wey's influence over 6D[—]publicly denied Wey's involvement in the company."[391] The complaint asserted that NASDAQ suspended trading in 6D's stock after an SEC complaint and a DOJ indictment revealed Wey's involvement in NYGG-Asia, and that the price of 6D stock dropped when trading resumed six months later.[392]

Reversing judgment on dismissal except as to one defendant,[393] the Second Circuit disagreed with the district court conclusion that the plaintiffs failed to plead loss causation.[394] The complaint alleged that the revelations in the enforcement actions about Wey's control over NYGG "caused NASDAQ to halt trading in 6D's shares."[395] Although the effect on 6D's share price was therefore delayed for six months and the lower court found no loss causation in part for that reason, "6D stock was not traded during those six months, pending 6D's appeal of the NASDAQ delisting. The Complaint alleges that once 6D trading resumed over the counter, its stock value declined from $2.90 to $0.21 over the course of four days."[396] While the district court also found the loss causation allegations inadequate because the resignation of 6D's auditor "rather than the revelation of Wey's involvement in NYGG-Asia, may have caused 6D's delisting," it sufficed for the Second Circuit that "NASDAQ's delisting letter indicate[d] . . . concerns over Wey's involvement in 6D substantially contributed to the delisting . . . even if the auditor's resignation was the final straw."[397]

Revelation of government subpoena as corrective disclosure. The Fourth Circuit published in 2018 a decision addressing whether pleading announcement of a government investigation, followed by a stock price decline, successfully alleged loss causation.[398] The issuer produced a medical device "designed

that the figure "failed to meet expectations because Whole Foods' customers took exception to the possibility of being defrauded and voted with their feet." *Whole Foods*, 905 F.3d at 904.

388. Puddu v. 6D Glob. Tech., Inc., 742 F. App'x 553 (2d Cir. 2018).

389. *Id.* at 554–55.

390. *Id.* at 555.

391. *Id.* at 556.

392. *Id.* at 557.

393. *Id.* at 555, 557. While the allegations against the 6D CEO and CFO sufficed to plead scienter against the two of them, *supra* text at note 391 and *6D*, 742 F. App'x at 556, the complaint was "devoid of factual allegations that could support a plausible inference of scienter" as to the third individual defendant, *id.* at 556 n.2.

394. *6D*, 742 F. App'x at 557.

395. *Id.*

396. *Id.*

397. *Id.* (alterations added).

398. Singer v. Reali, 883 F.3d 425 (4th Cir. 2018).

for minimally invasive surgery on the lower lumbar spine to treat degenerative disc disease."[399] While the Current Procedural Terminology codes ("CPT codes") initially permitted surgeons to identify procedures performed with the device with a Category I code—which permitted reimbursements from insurers to the surgeons and the issuer—the AMA in January 2009 changed the coding to Category III.[400] The change categorized procedures performed with the device as "'experimental'" and that meant surgeons and the issuer often could obtain no reimbursement at all.[401]

The issuer reported losses from 2009 to 2011.[402] On October 17, 2011, the issuer filed a Form 8-K disclosing receipt of a subpoena from the Department of Health and Human Services ("DHHS") pursuant to false claims statutes.[403] The next day an analyst report stated that (i) half of the issuer's revenues derived from procedures for which physicians were still using Category I codes and (ii) the subpoena sought, among other things, communications with doctors about reimbursement.[404] On October 18, the issuer's stock price declined by more than 40 percent.[405]

Investors filed Rule 10b-5 claims against the issuer and officers, alleging "that the Company had concealed the fraudulent reimbursement scheme from the market by way of false and misleading statements and omissions—and that [the issuer's] stock price dropped precipitously when the scheme was finally revealed."[406] The class period ran from February 23, 2009, to October 17, 2011, when the issuer filed the 8-K disclosing the DHHS subpoena.[407] More specifically, the complaint alleged that the defendants perpetrated a "scheme . . . 'to convince surgeons to engage in improper reimbursement practices in direct violation of' various statutes, including the federal False Claims Act."[408] Among other things, the issuer "formed a reimbursement committee to train surgeons on how to avoid the mandatory Category III code for the System," with the head of the committee providing "presentations detailing exactly which non-Category III codes to use and in what manner," instructing doctors to "bury" Category III codes in reimbursement claims so that insurers might overlook them, and establishing a "hotline" that doctors could call for coding assistance.[409] The issuer also prepared and distributed a guide to help surgeons obtain reimbursement, with that guide saying only on its final page that Category III coding was required and reimbursement was accordingly unlikely.[410]

399. *Id.* at 429.
400. *Id.* at 430.
401. *Id.*
402. *Id.* at 432–33.
403. *Id.* at 433.
404. *Id.* at 433–34.
405. *Id.* at 434.
406. *Id.* at 428. The issuer filed for bankruptcy protection after the investors sued, with the case continuing thereafter against the officers only. *Id.* at 436.
407. *Id.* at 429.
408. *Id.* at 430 (quoting complaint).
409. *Id.* at 430–31.
410. *Id.* at 431.

While allegedly in these ways encouraging physicians to *improperly* code procedures performed with the device, the defendants made statements that misled.[411] For example, on the first day of the class period, the CEO "stated that the Company was assisting surgeons in obtaining . . . '"*appropriate* reimbursement for our procedure."'"[412] As another example, the issuer's Form 10-Ks and 10-Qs "variously touted a growing acceptance of the [device] among health insurers and providers, and attributed revenue losses to '"concerns and uncertainty in the marketplace surrounding physician reimbursement for our . . . procedure,"'" while allegedly omitting "the Company's reliance on the fraudulent reimbursement scheme to generate the revenues that [the issuer] did have."[413]

After the district court dismissed on the grounds that the complaint pled neither misleading omissions nor scienter, the Fourth Circuit vacated and remanded.[414] As to misleading omissions, the court of appeals' majority noted that "the Officers informed the market that the Company was assisting surgeons in obtaining reimbursements for the System by way of, e.g., its 'hotline' and reimbursement guide."[415] The majority then held that "by choosing to inform the market that it was training surgeons on how to obtain reimbursements for [use of the device] in the wake of the AMA's Category III coding requirement, the Company was obliged to further disclose its fraudulent reimbursement scheme, i.e., its instructions to surgeons to unlawfully code the System under Category I."[416] That duty to disclose—self-imposed by the statements that defendants choose to make—"may extend to uncharged and unadjudicated illegal conduct."[417] And the majority emphasized that the Rule 10b-5 claim did "not depend on mere generic assertions of legal compliance to establish the Company's duty to disclose its fraudulent reimbursement scheme," but "relie[d] instead on the Company's choice to speak about its reimbursement practices—including, but not limited to, its efforts to train surgeons to attain '"appropriate"' reimbursements—without telling the whole, material truth."[418]

As to scienter, the majority read the complaint as alleging "the law was clear that, once the [device] was assigned the Category III code, only the Category III code could be used for the [procedures performed with the device]," and "the Company knew the law [as] . . . evidenced by its public acknowledgment of

411. *Id.* at 431–32.

412. *Id.* at 432 (quoting complaint, in turn quoting CEO) (emphasis added); *id.* at 429 n.2 (identifying the named officer as the CEO at the time).

413. *Id.* at 432 (citations omitted) (quoting complaint, in turn quoting SEC filings).

414. *Id.* at 429, 447.

415. *Id.* at 441.

416. *Id.* at 440. The majority added that "[t]he same is true of the Officers' statements that the Category III code was causing only limited losses; by not disclosing the Company's fraudulent reimbursement scheme and improper use of Category I codes, the Officers misled the market about the actual source of [the issuer's] continuing revenues." *Id.*

417. *Id.* at 441.

418. *Id.* at 442. The dissenter in this two-to-one decision rejected this analysis, stating that it "errs in its central assumption that the Company, if speaking about its reimbursement practices at all, not only had to characterize those practices fairly, but also had to further describe them as fraudulent or illegal." *Id.* at 452 (Agee, J., dissenting).

the [device's] Category III code and related reimbursement issues."[419] "By alleging that the fraudulent reimbursement scheme was known to the Officers, clearly illegal, and fundamental to [the issuer's] financial success, the Complaint establishes that the Officers' failure to disclose the scheme presented a danger of misleading . . . investors—a danger that was also known to the Officers, or so obvious that the Officers must have been aware of it," and hence at least reckless in a Rule 10b-5 sense.[420]

Turning to the issuer's cross-appeal, the Fourth Circuit found the district court had properly concluded that the complaint adequately pled loss causation.[421] The investors alleged that "the Form 8-K and analyst report revealed to the market the following additional facts: that [the issuer] had received a subpoena on or about October 6, 2011, issued by the DHHS '"under the authority of the federal healthcare fraud and false claims statutes"'; that the items sought by the subpoena included '"reimbursement communications with physicians"'; and that, despite the [device's] nearly three-year-old Category III coding requirement and the Company's purported '"strong efforts to educate physicians about correct coding,"' approximately '"half of [the issuer's] revenues [were coming] from physicians still using [a Category I] code."'[422] These were "enough facts for the market to finally recognize what the Officers' previous statements had materially omitted: the existence of the Company's fraudulent reimbursement scheme to encourage surgeons' continued use of a Category I code for the [device], rather than the mandatory Category III code, and to thereby bolster [the issuer's] [device]-dependent revenues."[423] These allegations were therefore sufficient to plead that the now-revealed omitted facts were at least one substantial cause of the immediately following 40 percent decline in the stock price and, accordingly, enough to successfully plead loss causation.[424]

Significance and analysis. Courts seem to be trending away from the heuristic that revelation of a government investigation or the filing of a civil lawsuit cannot

419. *Id.* at 443 (majority opinion).

420. *Id.* at 444; *id.* at 443 (defining recklessness for Rule 10b-5 purposes). The dissenter disagreed, noting that the complaint nowhere alleged that the defendants knew that the company's reimbursement actions were illegal. *Id.* at 453 (Agee, J., dissenting). Nor did the complaint allege that the defendants urged doctors to omit the Category III coding; at most, the issuer counseled using multiple codes. *Id.* at 453–54. The issuer settled a qui tam case in June 2013 by agreeing to pay $6,000,000 to the U.S. government on false claims allegations, though in doing so it denied liability. *Id.* at 435 (majority opinion). The dissenter pointed out that "[n]ot even the Company's settlement agreement with the Government 'indicate[s] that using multiple codes, in and of itself' is prohibited." *Id.* at 454 (Agee, J., dissenting) (quoting district court, Singer v. TranS1, Inc., No. 7:12-CV-00023-F, 2015 WL 13631184, at *3 n.1 (E.D.N.C. Dec. 8, 2015)).

421. *Id.* at 444–47.

422. *Id.* (quoting complaint).

423. *Id.* at 447.

424. *Id.* Again, the dissenter disagreed, reasoning that "[t]he primary revelation—that the Company had received a DHHS subpoena—is not actionable because it discloses only the fact of a DHHS investigation," and "fraud is but one of a panoply of reasons that a given company could be under investigation." *Id.* at 457 (Agee, J., dissenting). The dissenter also urged that the analyst report (i) did "not detail, describe, or discuss how, or even if, the Company violated" federal law and (ii) "state[d] only that the subpoena potentially concerned the Company's billing 'communications,' but called that hypothesis 'speculation.'" *Id.* at 457–58.

constitute a corrective event for loss causation because neither reliably shows wrongdoing.[425] The Fourth Circuit's decision joins that trend. Courts likely will look more in future decisions to make holistic judgments, fitting such a revelation into the mosaic of events to determine whether allegations of the investigation or civil suit plausibly link to stock price movement.[426]

The "in connection with" element. Rule 10b-5 applies only to fraud or manipulation "in connection with the purchase or sale of [a] security."[427] The Second Circuit held in 2018 that a plaintiff failed to allege that element with respect to part of its case, but succeeded in pleading that element as to the rest.

Charles Schwab Corporation ("Schwab") sued Bank of America and other banks, alleging that the defendants conspired to artificially suppress LIBOR.[428] Schwab claimed under Rule 10b-5 and under state law.[429] The district court dismissed.[430]

In affirming in part, vacating in part, and remanding,[431] the Second Circuit—as to the federal claim[432]—divided its analysis into two parts, one focusing on Schwab's claim that the defendants' manipulative suppression of LIBOR hurt Schwab when it invested in floating-rate securities and the other on Schwab's claim that the suppression hurt Schwab when it invested in fixed-rate securities.[433] As to the first category, Schwab "held floating-rate instruments that were tied to LIBOR" and alleged that "Defendants' manipulation of LIBOR allegedly caused Schwab to receive lower returns than it would have had LIBOR reflected Defendants' true borrowing costs."[434] As to the second, Schwab alleged that, in considering whether to buy a fixed rate security, it considered the spread between the fixed rate and LIBOR so that the suppression of LIBOR made lower fixed rates attractive, resulting in Schwab purchasing fixed-rate securities providing lower returns than it otherwise would have found acceptable.[435]

The Second Circuit then broke Schwab's claim on the floating-rate securities into two parts.[436] To the extent that Schwab argued that the defendant's conduct depressed the interest *Schwab* received on such securities *after it* purchased them but *before* it sold them, the court of appeals affirmed the dismissal on the ground that "[t]here is no authority for the proposition that an interest payment in itself

425. *See* ABA Bus. Law Section Fed. Regulation of Sec. Comm., *Annual Review of Federal Securities Regulation, Caselaw Developments*, 73 Bus. Law. 877, 934–36 (2018).

426. Indeed, the *Singer* majority characterized its analysis as "holistic." *Singer*, 883 F.3d at 447.

427. 17 C.F.R. § 240.10b-5 (2018).

428. Charles Schwab Corp. v. Bank of Am. Corp., 883 F.3d 68, 78–79 (2d Cir. 2018).

429. *Id.* at 79–80.

430. *Id.* at 78.

431. *Id.* at 78, 98.

432. The court of appeals limited its analysis to the Rule 10b-5 federal claim, *id*. at 92, even though Schwab also claimed under the Securities Act, *id*. at 79–80, and the text above is similarly cabined.

433. *Id.* at 92–96.

434. *Id.* at 78.

435. *Id.* at 78–79.

436. *Id.* at 92–93.

qualifies as a 'purchase or sale of a security.'"[437] But to the extent that Schwab argued that the prices at which it bought floating-rate securities might have been lower than they were without the alleged defendant's misconduct, the court of appeals reversed on the theory that "[a]lthough a depressed LIBOR that caused expectations of future interest payments to decrease might result in lock-step reductions in the price of floating-rate instruments, such an effect is not certain, and expert testimony might well demonstrate that, in light of Defendants' manipulation, Schwab's floating-rate instruments should have been priced even lower than they were."[438] Moreover, "[i]f Schwab held a mispriced instrument to maturity, for instance, it might have incurred damages based on the reduced cash flow received from interest payments that were depressed because of Defendants' manipulation."[439] And, "if Schwab tried to sell a floating-rate instrument after LIBOR manipulation was revealed, it might have been forced to sell at a loss."[440]

The Second Circuit, however, affirmed dismissal of the Rule 10b-5 claim insofar as it rested on fixed-rate securities.[441] As to these, the court of appeals held that the defendants' manipulation of LIBOR was not "in connection with" the purchase or sale of these securities—as required by Rule 10b-5[442]—because that deceptive conduct did not mislead Schwab as to the value of the fixed-rate securities it purchased.[443] Instead, "[w]hen Schwab purchased fixed-rate instruments, it received exactly what it expected" because those securities "did not reference or relate to Defendants' LIBOR submissions in any way."[444]

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437. *Id.* at 93 (quoting Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 267 (2014)) (relevant only because it reminds the reader, at the cited page, that a Rule 10b-5 claim must be based on the purchase or sale of a security; *Halliburton* itself does not address whether an interest payment constitutes a security).

438. *Id.*

439. *Id.*

440. *Id.* The Second Circuit rejected the defense argument that Schwab had failed to plead with sufficient particularity because "the complaint contains significant and sufficiently detailed allegations demonstrating that Defendants, in their daily submissions as members of the U.S. Dollar LIBOR panel, misstated their true borrowing costs" and thereby manipulated the LIBOR rate, which was based on those submissions. *Id.* at 78, 94. The court of appeals similarly rejected the argument that Schwab's claims failed because they were brought after passage of the two-years-after-discovery portion of the statute limiting fraud claims under the Exchange Act. *Id.* at 94–95 (citing 28 U.S.C. § 1658(b)). While UBS AG disclosed on March 15, 2011—more than two years before Schwab filed its suit in April 2013—that it had received subpoenas relating to LIBOR manipulation, "[e]ven if UBS's SEC filing would have led a 'reasonable investor to investigate the possibility of fraud,' such inquiry notice 'does not automatically begin the running of the limitations period' for Securities Exchange Act claims," which instead commences only after "an investigation [conducted by such an investor] would have given Schwab sufficient information to plead its claims with 'sufficient detail and particularity to survive a 12(b)(6) motion to dismiss.'" *Id.* at 95 (quoting City of Pontiac Gen. Emps.' Ret. Sys. v. MBIA, Inc., 637 F.3d 169, 173–74, 175 (2d Cir. 2011)).

441. *Id.* at 95–96.

442. *Id.* Rule 10b-5 makes "unlawful" "employ[ing] any device, scheme, or artifice to defraud"; "mak[ing] any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading"; or "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" "*in connection with the purchase or sale of any security*." 17 C.F.R. § 240.10b-5 (2018) (emphasis added).

443. *Charles Schwab*, 883 F.3d at 96.

444. *Id.*

Significance and analysis. In this last holding, *Schwab* demonstrates how the "in connection with" element of Rule 10b-5 differs from the reliance and loss causation elements. The court did not question whether Schwab relied on LIBOR when selecting between fixed-rate and floating-rate securities. Nor did it question that Schwab was harmed by selecting fixed-rate securities because the spread between them and floating rate debt was exaggerated by LIBOR manipulation. The idea seems to be that the defendants did not aim the manipulation at the fixed-rate market and therefore their actions were not "in connection with" purchases or sales in that market. This lines up nicely with *SEC v. Zandford*, which held that a broker's alleged violation of fiduciary duty to his clients was "in connection with" securities sales because the complaint "describes a fraudulent *scheme* in which the securities transactions and breaches of fiduciary duty coincide."[445] In *Schwab*, the alleged "scheme" did not encompass influencing the choice between fixed-rate and floating-rate debt based on the spread between the two.

Life sciences cases. The life sciences industry generates a large number of appellate securities opinions. These decisions address how companies describe their interaction with the FDA, as the companies seek approval from that agency to sell their drugs and devices. The following summary treats these cases together, even though they involve elements discussed in previous sections.[446] The First Circuit affirmed dismissal where the company (i) expressly cautioned that filing an NDA would require additional data and analysis and that the FDA had raised methodological concerns but (ii) did not disclose that the agency had requested an independent review of test site data.[447] The Sixth Circuit found that plaintiffs adequately alleged a Rule 10b-5 claim against a company that issued a press release characterizing FDA comments at a meeting as having endorsed use of a surrogate endpoint that would avoid multi-year testing, when the FDA's minutes of the same meeting stated that just such a lengthy test might be necessary before the agency approved the company's drug.[448] The Ninth Circuit held that, by releasing positive, early interim results from a clinical trial, a company created a duty to release later, negative interim results from the same trial.[449]

Disclosure sufficient where company stated FDA would require additional data and analysis but did not also state that the FDA requested independent review of data from a test site. Sarepta Therapeutics, Inc. ("Sarepta") announced on April 21, 2014 its intention to file—by the end of that year—an NDA for eteplirsen, a drug to treat a rare form of muscular dystrophy.[450] The

445. 535 U.S. 813, 825 (2002).

446. Note, however, that one of the loss causation opinions, *supra* notes 398–426 and accompanying text, also addressed Rule 10b-5 claims against a life sciences company.

447. *See infra* notes 450–74 and accompanying text.

448. *See infra* notes 475–506 and accompanying text.

449. *See infra* notes 507–56 and accompanying text.

450. Kader v. Sarepta Therapeutics, Inc., 887 F.3d 48, 53 (1st Cir. 2018). At the outset of the approval process, a pharmaceutical company must submit a new drug application ("NDA"). 21 U.S.C. § 355(a) (2018). The FDA does not "file" the application until it makes "a threshold determination that the NDA is sufficiently complete to permit a substantive review." 21 C.F.R. § 314.101(a)(1) (2018).

company was testing the drug "to determine if [it changed] the amount of dystrophin in [study participants'] muscle tissue . . . over time—a potential surrogate endpoint by which to assess eteplirsen's efficacy."[451]

Sarepta based its April 21, 2014 announcement on a guidance letter from the FDA.[452] In the press release, Sarepta caveated the news by saying that the FDA (i) advised that "'with additional data to support the efficacy and safety of eteplirsen . . . , an NDA should be fileable'"; (ii) "outlined examples of additional data and analysis that, if positive, will be important to enhance the acceptability of an NDA filing by addressing areas of ongoing concern in the existing dataset"; and (iii) "expressed concerns about methodological problems in the assessments of dystrophin and, 'remain[s] skeptical about the persuasiveness of the (dystrophin) data.'"[453] In a conference call with securities analysts and investors conducted on the day of the press release, Sarepta's CEO "cautioned . . . [that] 'the guidance letter described the FDA's reservations that the existing data set may not be sufficient to support an NDA filing, or be compelling enough for a favorable review.'"[454] In a May 7, 2014 further conference call, the CEO characterized the FDA guidance letter as saying:

> [W]e're not telling you you can't submit an NDA tomorrow on the existing data set. . . . But we're telling you that we've raised enough concerns on the existing data set that you would bolster your case for an NDA filing and potentially a favorable review if you allow us to do a more detailed review of your dystrophin methodology [and if you supplement the data set].[455]

Also in May, the FDA made a site visit to the hospital at which Sarepta had conducted its clinical tests.[456] On July 29, 2014, the FDA "requested that 'independent pathologists at independent labs' review Sarepta's primary dystrophin endpoint."[457] The company thereafter hosted another conference call at which the CEO again reminded the listeners that "'the FDA indicated in its April guidance that if, after further detailed review, they were to find the currently available dystrophin biomarker data to be adequate, our existing dystrophin data set would have the potential to support accelerated approval.'"[458] He did not, however, disclose the FDA request for independent review.[459] On October 27, 2014, Sarepta disclosed further FDA guidance requiring, "among other things, 'the results from an independent assessment of dystrophin images and the 168-week clinical data'" that would not be available for many weeks—with the result

451. *Sarepta*, 887 F.3d at 52. The court explained that a "surrogate" endpoint tests for a physiological change "that is 'reasonably likely' to predict the drug's clinical benefit." *Id*. Testing for such an endpoint is particularly useful when the ultimate benefit from the drug will not appear for many years, so that waiting for proof of that ultimate benefit will dramatically delay licensing. *Id*.

452. *Id*. at 53.

453. *Id*.

454. *Id*.

455. *Id*. at 54 (alterations by the court with one alteration deleted) (quoting CEO).

456. *Id*.

457. *Id*.

458. *Id*.

459. *Id*. ("Sarepta did not disclose this request to the public during the class period.").

that the company would not submit its NDA until some date in 2015.[460] On October 30, 2014, the FDA—responding to communications from patients suffering from the type of muscular dystrophy eteplirsen was designed to alleviate, and their families and friends—(i) stated "that '[i]n its advice to Sarepta, FDA has consistently stated that it would be necessary to include data in its NDA demonstrating that eteplirsen increases production of the muscle protein dystrophin'"; (ii) reported that its May visit to the site of eteplirsen testing "'did not find any evidence of fraud,'" but that the agency was concerned "'that the methods used to measure dystrophin were not adequately robust to support an NDA submission'" and that the visit "'reinforced . . . the need for additional data and analysis'"; and (iii) stated that "the FDA had 'provided Sarepta with detailed recommendations on how to improve these dystrophin analyses.'"[461] On the other hand, the FDA "recognized Sarepta's April 2014 announcement of its 'plans to submit an NDA for eteplirsen by the end of 2014,' without objecting to it or otherwise characterizing it as misleading or unfounded."[462]

The company stock price, which had increased by 39.26 percent following the April 21 announcement, declined by 32 percent after the October 27 disclosure.[463] Investors brought a Rule 10b-5 claim against Sarepta and two officers including the CEO, alleging fraud between those two dates[464] by statements that "knowingly or recklessly misled investors about [Sarepta's] target date" for submitting an NDA seeking eteplirsen approval.[465]

Affirming dismissal,[466] the First Circuit rejected as unreasonable the inference that the FDA's October 30, 2014 statement "supports the inference that the FDA had previously told Sarepta that its data were categorically inadequate" and thereby shows as false Sarepta's "continued representations that a 2014 NDA submission was possible."[467] "[C]rucially," the court wrote, the FDA specifically referred in the October 30 statement to Sarepta's April announcement of the company's intent to file in 2014 without criticizing that announcement.[468] Turning to whether Sarepta misled in the August 7 conference call by "its continued assertion . . . that its existing data set could support accelerated approval"—without disclosing the FDA's July request for an independent review—the court concluded "it is hardly obvious that the July request for independent review was significantly new and that compliance with it was more mandatory than what had come before" or was "materially different in its potential impact on the likelihood of approval" from the facts that Sarepta had already disclosed—

460. *Id.*
461. *Id.* at 54–55, 57.
462. *Id.* at 57–58.
463. *Id.* at 54.
464. *Id.* at 53 (identifying April 21 as "the first day of the Class Period"); *id.* at 54 (identifying October 27 as "the last day of the Class Period"); *id.* at 55 (stating that the plaintiffs sued under Rule 10b-5 and identifying the defendants).
465. *Id.* at 51.
466. *Id.* at 51, 62.
467. *Id.* at 57.
468. *Id.*

i.e., "that the FDA was saying that further review by someone other than Sarepta would affect the chances of approval."[469]

Passing then to scienter, the First Circuit found the plaintiffs' argument centered on the same facts as the last part of their argument that the defendants had misled—namely that the defendants' intent to defraud could be inferred from the CEO's failure to disclose the FDA's July 29 request that independent pathologists review the company's clinical test data when the CEO said that the company "'continue[d] to work with the FDA to provide greater assurance of the quality and reliability of our dystrophin data in anticipation of a potential NDA filing decision and potential NDA review next year.'"[470] Taking into account that the CEO expressly stated that the company was "'continu[ing] to work with the FDA to provide greater assurance of the quality and reliability of our dystrophin data,'" and that the CEO "gave no assurance that Sarepta would accede to the type of review that the FDA sought," the "difference between [what he said] and what exactly happened is not obvious."[471] Applying the rule that, where the defendants' statements only "arguabl[y]" misrepresent, the First Circuit concluded that any "marginal difference" between the CEO's implication that the further review to which the FDA referred might be conducted by the agency itself rather than by independent doctors outside the agency was not a difference from which "one might reasonably infer scienter."[472]

Significance and analysis. *Sarepta* joins a line of cases in which courts decline to find a strong inference of scienter when they find a plaintiff's argument of materiality plausible yet weak.[473] This analysis works best in a case like *Sarepta*, where the defendants disclosed many negative facts but did not disclose the one on which the plaintiff relies to show misleading conduct and where the one not disclosed is close to the others that were disclosed. But it is vital that courts recognize that the various elements of a Rule 10b-5 claim are different. Courts should blend them together only with caution. It is quite possible for a defendant to intend to defraud by deliberately withholding a fact that is not material and, considering the holistic view that the Supreme Court has mandated for scienter analysis, it is conceivable that pleading facts to show such an intent

469. *Id.* at 58.

470. *Id.* at 54, 58–59.

471. *Id.* at 59.

472. *Id.* The court similarly found unpersuasive the plaintiffs' contention that the August 7 statements showed deception because they failed to disclose "that Sarepta was not complying with the FDA's request for independent review." *Id.* The request from the FDA for the independent review was just that—a request—and the FDA's October 20 statement "did not describe compliance with its July 29, 2014 request as a mandatory prerequisite for a successful NDA filing." *Id.*

473. The First Circuit cites to *Flannery v. SEC*, 810 F.3d 1, 9 (1st Cir. 2015), which itself quotes from *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Waters Corp.*, 632 F.3d 751, 757 (1st Cir. 2011), for the proposition that "[i]f it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness in not disclosing the fact."

as to that *immaterial* fact could contribute to, though not establish, a strong inference of scienter as to misrepresentations and omissions that *are material*.[474]

Company summary of meeting with FDA actionable where the FDA's minutes of that meeting differed over whether the agency indicated that a long-term outcome study would be needed for licensing rather than a short-term study of a surrogate endpoint. Issuer reports of communications with the FDA lay at the heart of *Dougherty v. Esperion Therapeutics, Inc.* as well.[475] Esperion completed Phase II clinical studies and met with FDA officials in August 2015 to discuss Phase III trials for an oral medication (ETC-1002) developed to lower LDL cholesterol.[476] After the meeting but before the FDA provided its minutes to Esperion, the company issued an August 17, 2015 press release containing two statements that later figured into the litigation: (i) "'[t]he FDA confirmed that LDL-C remains an acceptable clinical surrogate endpoint for the approval of an LDL-C lowering therapy such as ETC-1002 in patient populations who have a high unmet medical need, including patients with [heterozygous familial hypercholesterolemia aka HeFH] . . . or [atherosclerotic cardiovascular disease aka ASCVD]" and (ii) "[b]ased upon feedback from the FDA, approval of ETC-1002 in the HeFH and ASCVD patient populations will not require the completion of a cardiovascular outcomes trial."[477] Taken together, these statements provided the important information that Esperion could satisfy Phase III testing requirements—without a cardiovascular outcomes trial ("CVOT") that would take years to complete in order to demonstrate directly that ETC-1002 reduced heart health risks—by showing that ETC-1002 lowered LDL-C levels (in trials that could be completed in a substantially shorter time), on the theory that reduced LDL-C levels benefit heart health and therefore constitute "a 'surrogate endpoint,' or proxy, for cardiovascular risk."[478]

474. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322–23 (2007) (in analyzing whether a complaint pleads facts supporting a strong inference of scienter, "courts must consider the complaint in its entirety . . . . The inquiry . . . is whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard").

475. 905 F.3d 971 (6th Cir. 2018).

476. *Id.* at 975–76. The opinion included this summary of the three phases:

> Phase I studies generally involve twenty to eighty subjects, and are designed to determine how the drug works in humans and the side effects associated with increasing doses. [21 C.F.R.] § 312.21(a)(1). Phase II studies usually involve no more than several hundred subjects, and are designed to evaluate the effectiveness of the drug, as well as common short-term side effects and risks. *Id.* § 312.21(b). Phase III studies are large-scale trials, usually involving several hundred to several thousand subjects, and are intended to gather the information necessary to provide an adequate basis for labeling the drug. *Id.* § 312.21(c). . . . After Phase III, the FDA considers the results of all of the clinical trials in determining whether to approve a drug for market. *See id.* §§ 314.125(b), 314.126(a).

Id. at 976 (quoting N.J. Carpenters Pension & Annuity Funds v. Biogen IDEC Inc., 537 F.3d 35, 39 (1st Cir. 2008)).

477. *Id.* at 976 (alterations by the court, except definitions for abbreviated terms) (quoting the press release) (internal quotation marks omitted).

478. *Id.*

In an analyst conference call following the press release, the Esperion CEO confirmed that the FDA would not require the company to complete a CVOT before licensing ETC-1002 for use in patients suffering HeFH and ASCVD.[479] However, the CEO "stressed the importance of receiving the FDA's final minutes from the meeting," saying specifically that "'[t]he FDA's minutes are the only minutes that matter.'"[480] After the FDA provided the company with those minutes, Esperion published a September 28, 2015 press release saying "that the 'FDA has encouraged the Company to initiate a cardiovascular outcomes trial promptly, which would be well underway at the time of the New Drug Application submission and review, since any concern regarding the benefit/risk assessment of ETC-1002 *could necessitate a completed [CVOT] before approval*.'"[481] The price of Esperion stock fell by 48 percent the next day.[482]

Investors who bought the stock between the August 17 and September 28 press releases filed a Rule 10b-5 action against Esperion and the CEO, contending that the first release and the CEO's conference call comments misled by falsely stating that the company would not need to complete a CVOT in order to win FDA approval.[483] The Sixth Circuit reversed the district court's dismissal, holding that—contrary to the lower court's conclusion—the plaintiffs pled facts raising a strong inference of scienter.[484]

Focusing on the *Tellabs'* passage enunciating the pleading test as whether, "tak[ing] into account plausible opposing inferences," "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged,"[485] the Sixth Circuit compared (i) the plaintiffs' explanation for the difference between Esperion's August 17 account of the meeting and the official FDA minutes with (ii) the company's explanations.[486] The plaintiffs' explanation was "straightforward"—that the company and its CEO had "knowingly or recklessly" misreported the FDA's statements.[487] The defense offered two alternatives. The first defense explanation rested on the FDA having, after the meeting, "change[d] its positions regarding the necessity of a completed pre-approval CVOT and the viability of LDL-cholesterol as a proxy for cardiovascular risk" and inserted those changes into the "minutes."[488] But the defense "provide[d] no reason why the FDA would have changed its position following the . . . meeting."[489] The second defense explanation—that "it 'might have left the meeting with a different impression than the FDA minutes ul-

479. *Id.* at 976–77.
480. *Id.* at 977.
481. *Id.* (emphasis added).
482. *Id.*
483. *Id.* at 977–78.
484. *Id.* at 975, 984.
485. *Id.* at 979 (quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 323–24 (2007)).
486. *Id.* at 979–81.
487. *Id.* at 979–80.
488. *Id.* at 980.
489. *Id.*

timately reflected'"—suggested at least recklessness by the company, given that Esperion at the time had no product yet licensed for sale, the success of the company therefore depended on FDA approval for ETC-1002, and that "adding a completed CVOT as a prerequisite to approval makes an already arduous process more costly and lengthy."[490] Put another way, what the FDA said about the CVOT was so important that, "[i]f Esperion is conceding" by this second explanation "that it was told by the FDA that it must complete a CVOT, but then mistakenly told its investors the exact opposite, this supports Plaintiffs' inference of recklessness."[491] Since only the first defense explanation was therefore benign and since it was "implausible," the defense had "offered no innocent inference stronger than Plaintiffs' inference that Esperion knowingly or recklessly made material misrepresentations or omissions" in the August press release and the CEO's conference call remarks.[492]

All of this rested on the conclusion that the defendants had acted at least with "recklessness . . . defined as 'highly unreasonable conduct which is an extreme departure from the standards of ordinary care . . . akin to conscious disregard.'"[493] The defendants, however, contended that their "August statements that the FDA had confirmed that it would not require completion of a CVOT prior to approving ETC-1002 looked toward the prospect of future approval" and were therefore forward-looking statements protected by Exchange Act section 21E.[494] That statute provides that, for a private plaintiff to recover on a statement protected by that section, the plaintiff must prove that the statement was made with "actual knowledge" that it was "false or misleading."[495] Recklessness is not enough.[496]

The protection applies, however, only to a "forward-looking statement." The definition of that term includes "a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer" as well as "any statement of the assumptions underlying or relating to" such plans or objectives.[497] The Sixth Circuit held that the August statements that the plaintiffs challenged did not fall within those phrases.[498] While acknowledging "that Esperion's statements concern an event in the future," the court ruled "that alone does not automatically make them for-

490. *Id.* at 975, 980, 981.

491. *Id.* at 980–81.

492. *Id.* at 982.

493. *Id.* at 980 (alteration within internal quotation by the court) (quoting PR Diamonds Inc. v. Chandler, 364 F.3d 671, 681 (6th Cir. 2004)).

494. *Id.* at 982–83 (citing 15 U.S.C. § 78u-5(c)(1)(A)–(B)).

495. *Id.* at 983 (quoting 15 U.S.C. § 78u-5(c)(1)(B)).

496. *See* Nathenson v. Zonagen Inc., 267 F.3d 400, 409 (5th Cir. 2001) ("severe recklessness" suffices for scienter "except as otherwise provided in the noted statutory safe harbor provisions respecting forward-looking statements and joint and several liability"). In addition, a covered representation is not actionable in a private action if identified as a forward-looking statement and "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. § 78u-5(c)(1)(A)(i) (2018). This second protection, however, did not figure into the *Esperion* decision.

497. 15 U.S.C. § 78u-5(i)(1)(B) & (D) (2018).

498. *Dougherty,* 905 F.3d at 983–84.

ward-looking statements."[499] Employing the criterion that a representation is not forward-looking for the purpose of the protective statute if "'its veracity can be determined at the time the statement is made,'"[500] the court of appeals concluded that the defendants' report on what the FDA had told the company in the August meeting fell outside the statutory protection.[501] And while the defendants contended that their report qualified as "assumptions underlying" a "forward-looking prediction about the regulatory environment," the Sixth Circuit rejected that view because "here, Esperion's statements were phrased as an observation of a historical fact ('The FDA *confirmed* . . . ')."[502]

Significance and analysis. The Sixth Circuit's decision prompts two comments. First, *Esperion's* analysis of recklessness seems ill elaborated. The decision could be read as suggesting that it is incredible that a company could misunderstand a regulator's statements about any issue that was of great importance to the company. Such a reading would ignore the reality that any counterparty (whether a regulator or not) can make statements over the course of a meeting that leave its position on an issue ambiguous and subject to interpretation. Whether that occurs depends on the language the counterparty uses, not the importance of the issue. *Esperion* may be more usefully understood to mean that, when the regulator (or other counterparty) speaks so vaguely that an issuer has to exercise judgment to interpret the counterparty's position, the probability that the issuer will be found reckless in providing its characterization of that position increases with the importance of the issue to the issuer's business. Put plainly, the more important the issue, the more care the issuer must take in deciding whether its characterization is correct and the stronger the caveats the issuer should include in its report to the investment community. In that regard, it is significant that the Sixth Circuit found the facts supported a strong inference of at least recklessness even though the Esperion CEO included in his August 2015 analyst call the seemingly robust caveat that "[t]he FDA minutes are the only minutes that matter."[503]

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499. *Id.* at 983.

500. *Id.* (quoting Julianello v. K-V Pharm. Co., 791 F.3d 915, 921 (8th Cir. 2015)).

501. *Id.* ("When Esperion made its statements in August, the company knew what the FDA had told it during the End-of-Phase 2 meeting. Therefore, the truth or falsity of Esperion's statements was discernible at the time they were made.").

502. *Id.* at 983, 984. Moreover, even if the August statements were in some respects forward-looking, statements of fact intermingled with forward-looking representations may be separated out for liability without regard to the statutory protections. Applying that principle here:

> Esperion's August statements regarding what the FDA purportedly said during the End-of-Phase 2 meeting—that "[t]he FDA confirmed that LDL-C remains an acceptable clinical surrogate endpoint for the approval of an LDL-C lowering therapy," and that "[w]e know that [ETC-]1002 will not require a CV outcomes trial to be completed prior to approval in . . . those patient populations that the FDA considers to have an appropriate benefit/risk ratio"—are separable statements of fact that are not merely assumptions upon which forward-looking statements were made.

Id.

503. *See supra* note 480 and accompanying text.

Second, *Esperion*'s forward-looking statement analysis wrestles with the difficult question of whether the protection for forward-looking statements applies to historical facts provided in the course of predictive prose. That question brings to mind the Supreme Court's *Omnicare* opinion, in which Justice Kagan identified three ways in which an opinion can be false or misleading for securities law purposes.[504] In one of those, Justice Kagan wrote that liability could attach if the defendant embeds a false statement of fact in the writing or oral presentation in which the defendant expressed the opinion.[505] Since forward-looking statements are by their very nature opinions, this analysis suggests the Sixth Circuit employed just that approach—separating out statements of historical fact (what the FDA said) from any express or implied prediction (what the FDA's position meant for possible approval of ETC-1002), with liability for the historical facts addressed through standard Rule 10b-5 protocols, without the complications imposed by Exchange Act section 21E.[506]

While this analysis helps, it does not answer a fundamental question. The statute expressly protects "underlying assumptions." And that category of protected statements is *additive* to the other protected categories, such as statements "of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer." What if Esperion had simply said, "We predict that we can file an acceptable New Drug Application with the FDA by the end of 2016, and we base this prediction on the assumption that the FDA would accept that filing without our having completed a CVOT"? Would the assumption then have fallen within the statutory protection so that it could only be successfully attacked by pleading facts raising a strong inference that the officers responsible for the statement had "actual knowledge" that it was false or misleading, not just that they were reckless with regard to whether it was true or not?

Revelation of initial, positive interim results can impose on a company the duty to disclose later interim results that are not positive. One more life sciences opinion deserves extensive discussion. Orexigen Therapeutics, Inc. ("Orexigen") developed an obesity drug called Contrave.[507] Orexigen conducted a clinical trial called the Light Study, to assess whether Contrave increased or decreased the probability that obese patients experienced major adverse cardiovascular events ("MACE").[508] The company agreed to a data access plan ("DAP") with an Executive Steering Committee ("ESC") and a Data Monitoring Committee created as required by the FDA, and the DAP required Orexigen to limit access to results compiled when the study reached a particular milestone—25 percent of a predetermined number of MACE events ("the 25 percent interim

504. Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1326–29 (2015).

505. *Id.* at 1327.

506. *See supra* notes 495–96, 502 and accompanying text.

507. Khoja v. Orexigen Therapeutics, Inc., 899 F.3d 988, 994 (9th Cir. 2018), *petition for cert. filed*, No. 18-1010 (Jan. 31, 2019).

508. *Id.*

results").[509] However, when the company received those results in November 2013 and the results showed that Contrave reduced cardiovascular results by 41 percent in comparison with a placebo, the company disclosed those numbers to more than 100 individuals.[510] The FDA then required that company executives agree to forebear from further disclosing the 25 percent interim results and agree to a new DAP further limiting access to interim results.[511] At a June 4, 2014 meeting, the FDA told the Orexigen CEO and Head of Global Development "that the leaked results—representing only 25 percent of the pre-determined amount of MACE required for the study—have 'a high degree of uncertainty and were likely to change with the accumulation of additional data.'"[512]

In July 2014, the company submitted an application to the U.S. Patent and Trademark Office ("USPTO") that contained the 25 percent interim results but was confidential.[513] After the European Medicines Agency ("EMA") advised Orexigen that it would review a draft decision to permit the company to market Contrave in Europe, the company requested the USPTO to publish the patent application, which it did on March 3, 2015, after informing Orexigen in advance;[514] whereupon the company filed an 8-K describing the application, including the 25 percent interim results.[515] And the company issued a press release announcing the USPTO's publication of the application.[516] Analysts made positive statements, and Orexigen's stock price climbed from $5.79/share to $9.37/share, closing at $7.64/share.[517] One FDA official stated that the agency "was 'very disappointed by Orexigen's actions,'" and another reportedly "'condemn[ed] [the 8-K] as "unreliable," "misleading," and "likely false."'"[518]

On March 26, 2015, the ESC (i) told the company that "as the Light Study reached 50 percent completion ('50 percent interim results'), the Light Study no longer indicated a heart benefit from Contrave," and (ii) in reaction to Orexigen's repeated disclosure of the 25 percent interim results, voted to end the Light Study.[519]

On May 8, 2015, Orexigen filed both an 8-K and a 10-Q, and hosted an investor conference call.[520] The 8-K stated that "'[t]he clinical trial program also includes a . . . trial known as the Light Study,'" and the 10-Q that "'additional analysis of the interim results or new data from the continuing Light Study . . .

509. *Id.* Specifically, the company promised to restrict access to "only 'those individuals at [Orexigen] who needed to facilitate its regulatory filings with the FDA.'" *Id.* (alteration by the court).

510. *Id.* at 995.

511. *Id.* The agency further required Orexigen to conduct a new trial to study the relationship between Contrave and cardiovascular effects. *Id.*

512. *Id.*

513. *Id.*

514. *Id.*

515. *Id.*

516. *Id.* at 1011.

517. *Id.* at 995.

518. *Id.* at 996 (quoting *Forbes* article).

519. *Id.* As the complaint put it, "on March 26, 2015, the ESC informed Orexigen that 'the ESC had voted unanimously to halt the Light Study as a result of [Orexigen's] improper March 3, 2015 disclosure breach.'" *Id.* at 1013 (alteration by the court).

520. *Id.* at 996.

may produce negative or inconclusive results, or may be inconsistent with the conclusion that the interim analysis was successful.'"[521] In the conference call, the CEO said expressly that if the study was terminated, the company would disclose that development.[522] But neither the SEC filings nor the executives' remarks on the conference call disclosed the 50 percent interim results or the ESC vote to end the Light Study.[523] On May 12, the head of the ESC issued a statement saying that "'[f]ollowing premature disclosure of interim study results, the 9,000-patient Light [Study] . . . has been halted by the [ESC]'" and advising "that the most recent results did not suggest a heart benefit from Contrave."[524] The price of Orexigen's stock fell from $6.75/share at the May 11 market open to $5.02/share at the May 13 close.[525]

Investors sued under Rule 10b-5 for fraud lasting from March 3, 2015, to May 12, 2015.[526] Reversing in significant part the district court's dismissal,[527] the Ninth Circuit analyzed five events to determine whether the plaintiff alleged materially false or misleading statements.[528] Turning first to the March 2015 8-K disclosing the USPTO publication of the patent application, the court noted that the filing—while containing the cautions that the 25 percent interim results were "early and preliminary" and that "[a] larger number of MACE are required to precisely determine the effect of Contrave on CV outcomes"—"included a graph that showed a lower occurrence of MACE in patients on Contrave than in patients on placebos."[529] The Ninth Circuit held that, "once Orexigen chose to tout the apparently positive 25 percent interim results, Orexigen had the obligation also to disclose that they were likely unreliable"[530] since the FDA had expressly told the company—before the 8-K filing—that the early figures were subject to "a high degree of uncertainty and were likely to change."[531] On the other hand, the court of appeals rejected the claim that in the March 2015 8-K Orexigen "misled investors because [the company] did not disclose that it had violated the DAP by releasing the 25 percent interim results."[532] Since the company "never touted having permission to publish the results," it "did not have a duty to share [the] information" that it was breaking an agreement by releasing the numbers.[533]

521. *Id.*
522. *Id.* at 996–97.
523. *Id.* at 1013–17.
524. *Id.* at 997.
525. Consolidated Complaint for Violation of Securities Laws at para. 26, Khoja v. Orexigen Therapeutics, Inc., 899 F.3d 988 (9th Cir. 2018) (No. 3:15-cv-00540 JLS (KSC)), 2015 WL 6549891 [hereinafter Khoja Compl.].
526. *Id.* at para. 2; *Khoja*, 899 F.3d at 997. The class period began on March 3, 2015, because that was the date on which the company filed the 8-K announcing the publication of the patent and simultaneously describing the 25 percent interim results. Khoja Compl., *supra* note 525, at paras. 15–17.
527. *Khoja*, 899 F.3d at 994, 1018.
528. *Id.* at 1009–17. "The district court's dismissal of Count I was based on the elements of falsity and materiality. Accordingly, the analysis here is limited to those issues." *Id.* at 1008.
529. *Id.* at 1009.
530. *Id.* at 1010.
531. *Id.*; *see supra* note 512 and accompanying text.
532. *Khoja*, 899 F.3d at 1011.
533. *Id.*

Moving, second, to the company's press release on the same day as the 8-K, the Ninth Circuit found that the statement in the release—"'the USPTO published the patent'"—gave "rise to a duty to elaborate."[534] Naked, that statement "plausibly [gave] the impression that the USPTO published the patent on its own," which was not true because the company, while initially filing the patent application confidentially, had asked that it be made public.[535] The omission was "arguably material" because it showed that "Orexigen had a direct role in revealing the 25 percent interim results, thus violating the FDA's rules again and risking the integrity of the Light Study," which "allegedly . . . impact[ed] the financial health of [the company]."[536]

The court then turned, third and fourth, to the May 8, 2015 8-K and 10-Q that the company filed on May 8, and the conference call it hosted on the same day.[537] By that date, the ESC had already voted to terminate that trial.[538] While the company argued and the district court concluded, on the basis of one passage in the complaint, that the ESC's vote was solely a recommendation,[539] the Ninth Circuit pointed to other allegations that "support a plausible inference that the ESC terminated the Light Study before May 2015."[540] Thus, "[b]y then stating [in the 8-K] that Contrave's 'clinical trial program also includes . . . the Light Study,' Orexigen gave the false impression that the Light Study was still underway."[541] The Ninth Circuit also concluded that the 8-K misled by failing to disclose the 50 percent interim results.[542] The court reasoned that (i) "[t]he 25 percent interim results were a boon to Orexigen," having raised the price of the company's stock and "suggested a promising venture" "even if investors understood that more results were necessary to confirm Contrave's potential heart benefit"; (ii) "if subsequent data indicated those earlier interim results were not so promising after all, their value diminished"; and (iii) therefore the company "had a duty to disclose" the 50 percent interim results because they "did precisely that."[543] The court then similarly concluded that the facts alleged in the complaint supported a claim that the May 8

534. *Id.* at 1012.

535. *Id.*; *see also supra* notes 513 and 514 and accompanying text.

536. *Khoja*, 899 F.3d at 1012–13. On the other hand, the court ruled that the company was not liable on the theory that the press release represented that the USPTO had "independently published" the application because the press release did not contain that statement. *Id.*

537. *Id.* at 1013–17.

538. *See supra* note 519 and accompanying text.

539. *Khoja*, 899 F.3d at 1013 (dismissing the complaint, the district court "relied on the Complaint's allegation that '[t]he executive committee voted unanimously to *recommend* that the trial be stopped,'" but had not halted the study; "[t]herefore, Orexigen could not have misrepresented or omitted something that had not yet occurred" (emphasis added)).

540. *Id.* at 1014 ("The Complaint quotes from a May 12, 2015 press release, which stated 'the 9,000-patient Light Trial—designed to study the cardiovascular safety of . . . Contrave . . . —has been halted by the trial's [ESC].' (Emphasis in Comp.) The phrase 'has been halted by the trial's [ESC]' clearly implies that (1) the ESC ha[d] the authority to halt (or terminate) a study and (2) the ESC already did precisely that with the Light Study." (one alteration added)).

541. *Id.*

542. *Id.* at 1015.

543. *Id.*

10-Q misled by "fail[ing] to disclose the termination of the Light Study and the 50 percent interim results."[544]

The court's analysis, fifth and finally, of the May 8 analyst call followed much the same reasoning, with the court concluding that the CEO's comments about disclosure the company "'would make'" "'if there was a decision to terminate the trial'" misled because the company already knew that the ESC had voted to terminate.[545] But in this discussion the Ninth Circuit added the fillip that Orexigen would have had a duty to disclose the ESC vote to terminate even if that had been only a recommendation because "[w]ith that information, a reasonable investor would understand that termination [might] be imminent."[546] As to the failure to disclose the 50 percent interim results, the Head of Global Development referred expressly in the call to the 25 percent interim results that were "'used for regulatory purposes,'" and said that "'if any of that status changes, then we would of course announce that'"—even though he "allegedly knew the 50 percent interim results indicated that Contrave did not have a heart benefit."[547] And the court repeated its earlier point that, regardless of what the company said on May 8, 2015, "by touting and publishing the 'surprisingly' positive 25 percent interim results [back in the March 8-K], Orexigen created its own obligation to report that those results did not pan out after all."[548]

In its analysis of the conference call, the Ninth Circuit also addressed the Hobson's choice Orexigen faced by May 8, 2015. In its DAP, the company had agreed with the ESC to forebear from disclosing interim results and had suffered when it violated that agreement.[549] Accordingly, it could only fulfill the duty to disclose the 50 percent interim results by violating its DAP again.[550] The court had no sympathy, observing that "Orexigen created this dilemma by violating the DAP in the first place."[551] It added that the company "cite[d] no law to suggest that its obligations under the DAP overrode its obligations under § 10 of the Securities Exchange Act and SEC Rule 10b-5."[552]

544. *Id.* The 10-Q referred to "'the *continuing* Light Study,'" which the court read the complaint as alleging had already been stopped. *Id.* at 1016. And the 10-Q "went on to say that the "'new data from the *continuing* Light Study . . . *may* be inconsistent with the conclusion that the interim analysis was successful,'" when the company knew already that the 50 percent interim results "revealed exactly that." *Id.* (emphasis in complaint).

545. *Id.* at 1016.

546. *Id.*

547. *Id.* at 1017 (emphasis by the court removed).

548. *Id.* As set out in the complaint, due to the publication of the patent on March 3 along with the 8-K filing, Piper Jaffray, an investment bank, issued a report referring to the findings as "*surprisingly positive*," and saying that the drug could "turn the obesity/metabolic syndrome market *on its head*." Khoja Compl., *supra* note 525, at para. 17. The March 3, 2015 8-K did not include the word "surprisingly," but did say that the 25 percent interim results were "unexpected." Orexigen, Inc., Current Report (Form 8-K) (Mar. 3, 2015), https://www.sec.gov/Archives/edgar/data/1382911/000119312515074251/d882841d8k.htm.

549. *See supra* notes 509 and 519 and accompanying text.

550. *Khoja*, 899 F.3d at 1017.

551. *Id.*

552. *Id.*

All of the substantive discussion summarized in the text concerned a count alleging violation of Rule 10b-5(*b*) that prohibits "mak[ing]" a false or misleading "statement." 17 C.F.R. § 10b-5(b)

Significance and analysis. Three of *Orexigen's* substantive holdings have lasting and widespread significance. First, the Ninth Circuit held that a drug company can, by reporting early results of clinical tests, create a duty to update as further results come in. This raises the stakes dramatically when a company considers releasing early results. And note that this duty is not extinguished by cautionary language stating that early results may be superseded by later results.[553] Second, *Orexigen* suggests that if the FDA has characterized interim results in some uncomplimentary way—here by allegedly telling the company that the 25 percent interim results were subject to "a high degree of uncertainty and were likely to change with the accumulation of additional data"[554]—the company may have to include some similarly uncomplimentary characterization in its announcement of the interim results—here the court suggesting that the company should have said that the results were "likely unreliable."[555] Third, the Ninth Circuit held that a confidentiality limitation imposed by a federal agency may not shield a company from an obligation to disclose under the securities laws—at least where the obligation to disclose arises from the company's previous breach of the confidentiality stricture.[556]

Section 16(b) application to option packages. Exchange Act section 16(b) provides that an issuer of a class of equity securities registered under section 12 of that act may recover from any 10 percent beneficial owner of that class, or from any of its officers or directors, "any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months."[557] To be liable, the defendant must have been an officer, director, or 10 percent shareholder *both* at the time of the relevant purchase *and* at the time of the matched sale.[558]

At a time when it owned over 16 percent of Repros Therapeutics, Inc. ("Repros") common stock, Perceptive Advisors LLC ("Perceptive") sold call options on that stock (giving the right to the holder to buy shares from Repros at a set strike price) and bought put options (giving Perceptive the right to sell Repros

(2018). The court ended its substantive discussion by affirming dismissal of a count in which the complaint alleged violation of Rule 10b-5(*a*) that prohibits "employ[ing] any device, scheme, or artifice to defraud" and (*c*) that prohibits "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." *Khoja*, 899 F.3d at 1017–18. The Ninth Circuit followed its rule that, to plead scheme liability under those two subsections, the plaintiff must allege "'conduct beyond . . . misrepresentations or omissions.'" *Id.* at 1017 (quoting WPP Lux. Gamma Three Sarl v. Spot Runner, Inc., 655 F.3d 1039, 1057 (9th Cir. 2011)). Here, the second count included a naked statement that the defendants' "'misconduct is distinct from the materially misleading statements pertaining to Count I,' but [did] not explain how." *Id.* This *Orexigen* holding is no longer good law in view of *Lorenzo v. SEC*, 139 S. Ct. 1094 (2019).

553. *See supra* note 529 and accompanying text.

554. *See supra* note 512 and accompanying text.

555. *See supra* note 530 and accompanying text.

556. *Khoja*, 899 F.3d at 1017 ("Orexigen cannot ignore the DAP to its benefit, then use it to conceal its own misconduct."). In a portion not summarized here, the *Khoja* opinion extensively discussed what documents—in addition to the complaint—a district court can properly consider on a motion to dismiss a securities case, ruling, document by document, on whether the lower court abused its discretion in that regard. *Id.* at 998–1008.

557. 15 U.S.C. § 78p(b) (2018).

558. *Id.* ("This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase . . . .").

shares at a set strike price), with both sets of options expiring on the same date.[559] The call options expired less than six months later because the price of Repros stock fell below the strike price.[560] Since "Perceptive's writing of call options . . . between January and March 2013 constituted Section 16(b) 'sales,'[561] while the expiration of those call options less than six months later, in March 2013, constituted Section 16(b) 'purchases,'" Perceptive would have been liable on the profit from the expiration of the calls (i.e., "the $1.7 million it had received when it sold those options")[562] if Perceptive was still a 10 percent owner at the time the expiration occurred.

Affirming dismissal of the derivative complaint seeking recovery for Repros of the $1.7 million,[563] the Second Circuit relied on the bylaws and rules of the Options Clearing Corporation ("OCC").[564] Those bylaws provided that the calls expired at 11:59 p.m. on March 16, 2013.[565] The bylaws provided, however, that puts with strike prices above the current market price were automatically exercised[566] and that the exercise occurred "immediately prior" to their expiration at 11:59 p.m. on March 16, 2013.[567] Since the automatic exercise of the puts sold so many shares that Perceptive's holdings dropped below the 10 percent threshold before the "purchases" occurred by expiration of the calls, Perceptive was not a 10 percent owner at the time of the purchases and those purchases could not be matched with the "sales" that Perceptive accomplished by writing the call options less than six months before.[568]

Extraterritoriality. In *Morrison v. National Australia Bank Ltd.*, the Supreme Court held that section 10(b) and Rule 10b-5 reach only two categories of purchases and sales: (i) "transactions in securities listed on domestic exchanges, and [(ii)] domestic transactions in other securities."[569] The Second Circuit thereafter

559. Olagues v. Perceptive Advisors LLC, 902 F.3d 121, 123 (2d Cir. 2018).

560. *Id.* at 127.

561. Though the opinion does not so state, purchases of the puts also constituted sales. 17 C.F.R. § 240.16b-6(a) (2018) ("[T]he establishment of or increase in a put equivalent position . . . shall be deemed a sale of the underlying securities for purposes of Section 16(b) of the Act.").

562. *Olagues*, 902 F.3d at 124, 127.

563. *Id.* at 123, 131.

564. *Id.* at 123 ("All of the options at issue were guaranteed by the OCC, an equity derivatives clearing organization made up of major U.S. broker-dealers, futures commission merchants, and non-U.S. securities firms, and were governed by the rules of the OCC and FINRA, an independent organization authorized by Congress to regulate the U.S. securities markets.").

565. *Id.* at 129.

566. *Id.* at 124.

567. *Id.* at 130.

568. *Id.* In sum, both selling the call options and buying the put options were sales for section 16(b) purposes. *See supra* note 561 and accompanying text. The exercise of the puts was neither a purchase nor sale. 17 C.F.R. § 16b-6(b) (2018). Only the expiration of the calls constituted a "purchase." And since Perceptive was—by the time of that purchase—no longer a 10 percent holder, that purchase could not be matched with either of the earlier sales to create section 16(b) liability.

569. 561 U.S. 247, 267 (2010). *Morrison* rejected a test by which section 10(b)'s application depended on "'(1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens.'" *Id.* at 275 (Stevens, J., concurring) (quoting Morrison v. Nat'l Austl. Bank Ltd., 547 F.3d 167, 171 (2d Cir. 2008)); *id.* at 261 (majority opinion) (concluding that the criticisms of the conduct and effects test are "justified").

held that a transaction is "domestic" within the second part of the *Morrison* test if "the purchaser incurred irrevocable liability within the United States to take and pay for a security, or . . . the seller incurred irrevocable liability within the United States to deliver a security[,]" or "title passe[d] within the United States."[570]

In *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, however, that circuit also held that the domesticity of a transaction in a security not listed on a U.S. exchange is a necessary but not sufficient condition to coverage by Rule 10b-5.[571] Where "the [Rule 10b-5] claims . . . are so predominantly foreign as to be impermissibly extraterritorial," the rule will not apply even if—by the circuit test just described—the underlying transaction is domestic.[572] The claims in *Parkcentral* involved swaps that referenced securities issued by a foreign company and traded on foreign exchanges, with the deceptive actions occurring primarily in a foreign country and prompting an investigation by authorities in a foreign country.[573] Under those peculiar circumstances, "incompatibility of U.S. and foreign law" was "nearly certain to arise,"[574] and accordingly, the comity concerns animating *Morrison* counseled—in the Second Circuit's view—against applying U.S. securities laws.[575]

In *Stoyas v. Toshiba Corp.*, the Ninth Circuit adopted the Second Circuit's test for geographically locating a transaction in order to determine whether it is "domestic" under *Morrison*, but declined to add the policy-driven exception set out in *Parkcentral*.[576]

Plaintiff purchased Toshiba ADRs "in the United States on an over-the-counter market."[577] Addressing first whether these purchases were subject to section 10(b) because they fell into *Morrison*'s first category of covered transactions—in "securities listed on domestic exchanges"—the Ninth Circuit observed that "Toshiba ADRs trade on OTC Link, an over-the-counter market operated by OTC Markets Group."[578] OTC Link was "registered with the Securities and Exchange Commission as a 'broker-dealer' alternative trading system"—a kind of platform that "is specifically exempt from the Exchange Act's definition of 'exchange.'"[579] Accord-

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570. Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 67–68 (2d Cir. 2012).
The Second Circuit applied this test last year to vacate dismissal of a claim that the Commodities Exchange Act's prohibition against manipulation reached a night market for Korean Exchange futures contracts because the operator of that market used its trading platform in Aurora, Illinois, to match buyers and sellers and, allegedly, that matching created an irrevocable obligation, despite the circumstance that the trades were settled the next day in Korea through a process that permitted rectification of errors. Myun–Uk Choi v. Tower Research Capital LLC, 890 F.3d 60 (2d Cir. 2018).

571. 763 F.3d 198, 216 (2d Cir. 2014).

572. *Id.*

573. *Id.* at 207–08.

574. *Id.* at 215–16.

575. *Id.*

576. 896 F.3d 933, 947–49 (9th Cir. 2018), *petition for cert. filed*, No. 18-486 (Oct. 15, 2018).

577. *Id.* at 937.

578. *Id.* at 945–46.

579. *Id.* at 946–47 (citing "15 U.S.C. § 78mm(a)(1); 17 C.F.R. §§ 242.300–303 ('Regulation ATS') (regulations that apply to alternative trading systems); 17 C.F.R. § 240.3a1-1(a)(2) (exempting entities in compliance with Regulation ATS from 15 U.S.C. § 78c(a)(1)'s definition of 'exchange'); Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 70844 (Dec. 22, 1998)").

ingly, "[t]he over-the-counter market on which Toshiba ADRs trade is simply not an 'exchange' under the Exchange Act."[580]

Turning then to whether the plaintiff's purchase fell into *Morrison*'s second covered category—as a "domestic transaction"—the court of appeals noted that, while the plaintiff alleged that its "ADRs were purchased in the United States" and "that Bank of New York, one of the depositary institutions, sold Toshiba ADRs in the United States," the complaint failed to include "specific factual allegations regarding where the parties to the transaction incurred irrevocable liability."[581] Given that (i) the plaintiff Automotive Industries Pension Trust was a "United States entity" with its headquarters in the United States and its executives "direct[ed], control[led], and coordinate[d] its activities in the [U.S.,]" (ii) "OTC Markets Group operate[d] OTC Link in the [U.S.,]" and (iii) the depositary institutions for Toshiba ADRs were "all in New York," the court reasoned that the plaintiff "could almost certainly" file an amended complaint alleging "sufficient facts to establish that [plaintiff] purchased its Toshiba ADRs in a domestic transaction."[582] Therefore, the district court—which had found no "domestic transaction" by applying an erroneous standard that focused on "Toshiba's involvement in the ADR transactions"—should not have dismissed the case with prejudice and without leave to amend.[583] Rejecting the lower court's reasoning, for which Toshiba argued on appeal, the court concluded that *Morrison*'s second category of covered purchases and sales focuses on "the location of the transaction," and it therefore "does not matter that a foreign entity was not engaged in the transaction."[584]

The Ninth Circuit then added that it would "not follow the *Parkcentral*" exception to the geographical test "because [the exception] is contrary to Section 10(b) and *Morrison* itself [by] . . . carv[ing]out 'predominantly foreign' securities fraud claims from Section 10(b)'s ambit, [and thereby] disregarding Section 10(b)'s text: the domestic 'purchase or sale of *any* security registered on a national securities exchange or *any* security not so registered.'"[585]

Significance and analysis. Had the Ninth Circuit ended with the holding just described, all would have been well. But the court went on to discuss whether the alleged accounting fraud by Toshiba, the defendant in the suit, was "in connection with" the plaintiff's purchase.[586] That discussion is hard to parse but suggested that the plaintiff needed to "sufficiently plead[] Toshiba's connection to the ADR transactions."[587] The court then wandered all over the lot—referencing (i) the plaintiff's "argu[ment] that 'it is likely that Toshiba was indeed involved in the establishment' of the ADRs" and even (ii) the plaintiff's "alleg[ation] that Bank of New York Mellon is one of Toshiba's largest ten shareholders" and that the

580. *Id*. at 945.
581. *Id*. at 949.
582. *Id*.
583. *Id*. at 937, 938, 949, 952.
584. *Id*. at 949.
585. *Id*. at 950 (quoting 15 U.S.C. § 78j(b)).
586. *Id*. at 950–52.
587. *Id*. at 951.

plaintiff might therefore include in a further amended complaint "that Bank of New York Mellon is unlikely to have acquired over fifty million Toshiba shares without Toshiba's involvement."[588]

It is settled law that the issuer's statements, when made in disclosures of a kind that investors will read, are sufficiently "in connection with" a transaction in the secondary market so as to satisfy that element of a Rule 10b-5 claim based on a plaintiff's purchase of that issuer's securities;[589] and further, that an issuer's fraud affecting transactions in its securities can impose Rule 10b-5 liability on the issuer even if the issuer is not a party to those transactions.[590] There is no basis in *Morrison* to support any idea that it was intended to somehow change this law by adding to the "in connection with" element—when a foreign company is the issuer—the requirement that the foreign company be itself involved in the transaction.[591]

As to the wisdom of the Ninth Circuit's disagreement with *Parkcentral*, that case—while it appropriately recognized that some release valve should be available to prevent a mechanical location test from applying U.S. securities law to transactions in highly engineered financial products based on the prices of foreign securities—does generate uncertainty and litigation costs.[592] Although the Ninth Circuit's categorical renunciation of *Parkland* seems overly doctrinal, the

588. *Id.* at 951–52.

589. *See* SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993) ("We have said that the 'in connection with' requirement is met if the fraud alleged 'somehow touches upon' or has 'some nexus' with 'any securities transaction.' *SEC v. Clark*, 915 F.2d 439, 449 (9th Cir. 1990). Where the fraud alleged involves public dissemination in a document such as a press release, annual report, investment prospectus or other such document on which an investor would presumably rely, the 'in connection with' requirement is generally met by proof of the means of dissemination and the materiality of the misrepresentation or omission."). Oddly, *Stoyas* does not cite *Rana*.

590. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968) (en banc) ("[I]t seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions . . . .").

591. Instead, as the Ninth Circuit correctly analyzed it, *Morrison*—in defining the second category of purchases and sales to which section 10(b) applies—focused simply on the location of the purchase or sale.

592. The Second Circuit last year itself decided a case in which the plaintiffs sought to stretch past *Morrison* based on *Parkcentral*'s reasoning. Giunta v. Dingman, 893 F.3d 73, 80 (2d Cir. 2018) (vacating dismissal and remanding on the basis that oral agreements in New York created "irrevocable" commitments despite the circumstance that "had the Bahamian authorities refused to approve the issuance of shares, [the defendant] 'was bound to return to [the plaintiff] all funds'" he had paid); *id.* at 81 ("[W]hether the circumstances allowing [the plaintiff] to 'revoke' his purchase would come to pass was an outcome entirely out of [the plaintiff's] control and depended solely on subsequent actions taken by the Bahamian authorities" so that "as a practical matter, [the plaintiff] was contractually obligated and he could not, on his own accord, revoke the Agreement. This is sufficient to satisfy the test for irrevocable liability."); *id.* at 82–83 (declining to invoke the *Parkcentral* caveat to the irrevocability test because "the SAC alleges substantial domestic contacts. The Agreement was entered into in New York; [the defendant] continued to press [the plaintiff] for further investments in New York; [the defendant] and [the plaintiff] were both U.S. citizens; the wire transfers originated from New York; and the confirmation letters were sent to New York. The only foreign component present in

court of appeals' caution in blurring the extraterritorial analysis with an imprecise policy exception makes sense.[593]

No private right of action against issuer and management for violation of conditions placed by the SEC on an exemption from ICA registration. ICA section 3(a) defines an "investment company" to include "any issuer which . . . is engaged . . . in the business of . . . owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."[594] The SEC can exempt from the definition any company "which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities."[595]

Yahoo! purchased stock in Alibaba, and as Yahoo!'s search engine business declined while Alibaba's retail website business burgeoned, the value of Yahoo!'s Alibaba stock came to comprise more than 40 percent of Yahoo!'s total assets.[596] The SEC granted Yahoo! an ICA exemption in 2000, subject to conditions that the company "could only make investments 'for bona fide business purposes' and had to 'refrain from investing or trading in [securities] for short-term speculative purposes.'"[597]

A Yahoo! shareholder sued the company, its board, and some executives, claiming (derivatively as to most claims and directly as to one) that the company had violated the conditions.[598] The shareholder sought rescission of executives' employment contracts, an injunction against the company "from further performing contracts signed in violation of the ICA and from selling any material assets," and damages.[599] Affirming dismissal, the Ninth Circuit held that the ICA did not provide a private action of the sort that the plaintiff brought.[600] The court found that "[t]he ICA provisions related to SEC registration and ICA exemptions do not have rights-creating language."[601] More specifically,

the formation of the Agreement was the eventual registration of the shares 'with the appropriate Bahamian authorities,' an act that [the defendant] agreed to undertake per the Agreement.").

593. The Court enunciated its test in *Morrison* in part because the then-popular conduct and effects test was so fuzzy that it created uncertainty. Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 257–61 (2010).

594. 15 U.S.C. § 80a-3(a)(1)(C) (2018).

595. *Id.* § 80a-3(b)(2).

596. UFCW Local 1500 Pension Fund v. Mayer, 895 F.3d 695, 697 (9th Cir. 2018). For example, Yahoo!'s 10-K for the year ended December 31, 2016, showed total assets of $48,083,079, of which $33,680,879 consisted of an "Investment in Alibaba Group." Yahoo! Inc., Annual Report (Form 10-K), at 94 (Mar. 1, 2017).

597. *UFCW*, 895 F.3d at 698; U.S. Sec. & Exch. Comm'n, Order Under Section 3(b)(2) of the Investment Company Act of 1940, *In re* Yahoo! Inc. (June 13, 2000), https://www.mintz.com/sites/default/files/viewpoints/orig/19/2016/11/Yahoo-SEC-Exemption.pdf (referring to conditions in Yahoo!, Inc., Notice of Application, 812-11976 (May 18, 2000), https://www.mintz.com/sites/default/files/viewpoints/orig/19/2016/11/Yahoo-SEC-Exemption.pdf).

598. *UFCW*, 895 F.3d at 698.

599. *Id.*

600. *Id.* at 697, 701.

601. *Id.* at 699.

the exemption provision in section 3(b)(2) "'focuses neither on the individuals protected nor even on the [parties] being regulated, but on the agenc[y] that will do the regulating'—the SEC," which "not only dooms any suggestion that Congress intended to create a private right, [but] forecloses any private remedy for alleged violations of an ICA exemption beyond (at best) a chance to file with the SEC an 'application' for revocation of the exemption, subject to (if anything) deferential judicial review."[602] Moreover, the ICA "expressly authorizes 'private suits for damages against insiders of closed-end investment companies who make short-swing profits' and derivative suits against 'an investment company's advisor and its affiliates for breach of certain fiduciary duties.'"[603] By implication, Congress "never intended" to create rights to private causes of actions by sections that do not expressly do so.[604]

The plaintiff argued that the section in the ICA providing that contracts made in violation of the Act are unenforceable established its "right of action for challenging the continued validity of an ICA exemption."[605] But "Congress contemplated that companies would contravene the conditions of ICA exemptions and concluded that the SEC, not the courts, should decide in the first instance what to do when that happens."[606] Moreover, if the plaintiff were correct, the section providing that statute-violative contracts are unenforceable would expand into a private right to rescind not only the "multi-billion-dollar sale of [Yahoo!'s] internet business"—a transaction to which the SEC had not objected "even though the SEC ha[d] been made fully aware" of it—but also to sue for rescission of almost "every . . . contract Yahoo! ha[d] entered into for the better part of a decade."[607]

Miscellaneous cases. The Eleventh Circuit held that SLUSA did not apply to bar state law claims that an annual fee a broker charged exceeded transaction and execution costs because any falsehood respecting the composition of the annual fee was not material to the purchase or sale of securities.[608] The Second Circuit held that state law claims, alleging that a broker directed trades to venues giving the broker the highest rebates even when the venues failed to provide best execution for customers, involved material misrepresentations relating to securities transactions and therefore were SLUSA-precluded.[609] The Ninth Circuit held that SLUSA precluded state law claims based on a fund's deviation from its fundamental investment policies.[610]

602. *Id.* (quoting Alexander v. Sandoval, 532 U.S. 275, 289 (2001)).

603. *Id.* at 701 (quoting 15 U.S.C. §§ 80a-29(h), 80a-35(b)).

604. *Id.* ("This detailed statutory scheme . . . indicated that Congress never intended further private enforcement of the ICA.").

605. *Id.* at 700.

606. *Id.*

607. *Id.* at 701.

608. Brink v. Raymond James & Assocs., 892 F.3d 1142 (11th Cir. 2018).

609. Rayner v. E*TRADE Fin. Corp., 899 F.3d 117 (2d Cir. 2018). The Eighth Circuit reached a similar conclusion on similar allegations. Lewis v. Scottrade, Inc., 879 F.3d 850 (8th Cir. 2018); Zola v. TD Ameritrade, Inc., 889 F.3d 920 (8th Cir. 2018).

610. Northstar Fin. Advisors, Inc. v. Schwab Invs., 904 F.3d 821 (9th Cir. 2018). But one judge dissented in part, arguing that the class of investors who bought before the deviation "did not need to prove a misrepresentation or omission in order to prevail on its breach of contract claim" and that

The Second Circuit held that a tipper received a personal benefit for providing a tip where the tippee helped the tipper secure counsel on a charge that threatened the tipper's visa, and that evidence remote tippees conspired to conceal their trades and lie about the source of their material nonpublic information was sufficient for a jury to infer that they knew the information derived from a breach of confidentiality for benefit, or consciously avoided acquiring such knowledge.[611]

The Fifth Circuit affirmed a 188-month sentence and held that violation of a FINRA order counted as violation of an "administrative order" for purposes of the sentence enhancement based on such violations.[612] The Eighth Circuit affirmed a 132-month sentence and an order for $3,122,696 in restitution by an opinion endorsing a loss computation—for purpose of determining the recommended length of imprisonment under the federal sentencing guidelines—of about $24,400,000, thereby demonstrating that loss and restitution numbers may be calculated very differently, even in the same case.[613]

SLUSA therefore did not bar that claim. *Id.* at 835–37 (Thomas, J.) (concurring in part and dissenting in part with quotation at 837).

611. SEC v. Payton, 726 F. App'x 832 (2d Cir. 2018).

612. United States v. Blount, 906 F.3d 381, 383, 385 (5th Cir. 2018) (referring to U.S. Sentencing Guidelines Manual § 2B1.1(b)(9)(C)).

613. United States v. Lundstrom, 880 F.3d 423, 443–47 (8th Cir. 2018).