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 2019. 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 2019, 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, as well as well as to adopt amendments to the Volcker Rule and to adopt a heightened standard of care for broker-dealers through Regulation Best Interest.

During 2019, 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, registered 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 2019

A. SEC Adopts Rules to Modernize and Simplify Disclosure

On March 20, 2019, the U.S. Securities and Exchange Commission (the "SEC") adopted amendments intended to modernize and simplify certain disclosure requirements of Regulation S-K and related rules and forms.[1] The amendments represent the next step in a series of steps that the SEC has taken to update and modernize the disclosure requirements in Regulation S-K. For example, in August 2018, the SEC adopted disclosure update and simplification amendments that became effective in November 2018.[2] We anticipate the SEC will continue to address other pending changes to Regulation S-K in the near future.

The amendments were adopted pursuant to the Fixing America's Surface Transportation Act (the "FAST Act").[3] The FAST Act required the SEC to prepare a report on modernizing and simplifying the disclosure requirements of Regulation S-K and related rules and forms, which the staff of the SEC (the "SEC Staff") completed in November 2016.[4] In October 2017, the SEC issued a proposal to implement the recommendations in that report.[5] According to the SEC's adopting release, these amendments "are intended to improve the quality and accessibility of disclosure in filings by simplifying and modernizing"[6] SEC requirements, consistent with the FAST Act.

The amendments cover many provisions within Regulation S-K and affect various forms that rely on the integrated disclosure requirements of Regulation S-K. The amendments are designed to enhance the readability and navigability of the SEC filings, to discourage repetition and disclosure of immaterial information, and to reduce the burdens on registrants, all while still providing material information to investors.[7] Many of the amendments are technical in nature. Some

1. FAST Act Modernization and Simplification of Regulation S-K, Release No. 33-10618, 84 Fed. Reg. 12674 (Apr. 2, 2019) (to be codified at 17 C.F.R. pts. 229, 230, 232, 239, 240, 249, 270, 274 & 275).

2. *See* 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).

3. Pub. L. No. 114-94, 129 Stat. 1312 (2015).

4. *See* U.S. Sec. & Exch. Comm'n, Report on Modernization and Simplification of Regulation S-K (Nov. 23, 2016).

5. *See* FAST Act Modernization and Simplification of Regulation S-K, Release No. 33-10425, 82 Fed. Reg. 50998 (proposed Nov. 2, 2017) (to be codified at 17 C.F.R. pts. 229, 230, 232, 239, 240, 249, 270, 274 & 275) [hereinafter Proposing Release].

6. FAST Act Modernization and Simplification of Regulation S-K, *supra* note 1, at 12676.

7. *Id.* at 12674.

amendments eliminate redundant or obsolete requirements or streamline the applicable rules. For consistency, parallel amendments have been adopted to rules other than Regulation S-K, as well as to forms for registration statements and reports. In some cases, the amendments require additional disclosure or use of technology. This section of the Review discusses highlights of the amendments.

1. MD&A

The pre-amendment instructions for management's discussion and analysis of financial condition and results of operations ("MD&A"), set forth in Item 303(a) of Regulation S-K, generally specify that discussion of the three-year period covered by the financial statements shall either use year-to-year comparisons or other formats that, in the registrant's judgment, would enhance a reader's understanding of a company's financial condition, changes in financial condition, and results of operations.[8] These instructions also state that where trend information is relevant, reference to five-year selected data may be necessary.[9]

The amendments eliminate the reference to year-to-year comparisons in the instructions to Item 303(a).[10] The revised instructions provide that a registrant may use any presentation that in its judgment enhances a reader's understanding of the registrant's financial condition, changes in financial condition, and results of operations, but does not suggest that any one mode of presentation is preferable to another.[11] The amendments to the Item 303(a) instructions also eliminate the need to discuss the earliest year in certain circumstances if financial statements included in a filing cover three years.[12] As amended, the discussion of the earliest year is not required in MD&A if discussion was already included in the registrant's prior filings on the SEC's Electronic Data Gathering and Retrieval ("EDGAR") system, provided that the registrant identifies the location in the prior filing where the omitted discussion may be found.[13]

The elimination of the earliest (i.e., the third) year discussion in the MD&A does not impact smaller reporting companies ("SRCs") or emerging growth companies ("EGCs").[14] The amendments do not change the existing rule allowing SRCs to limit their MD&A to the two-year period covered by their financial statements.[15] Nor do the amendments change the ability of EGCs to limit their MD&A to audited periods presented in the financial statements when the EGCs provided two years of audited financial statements in connection with an initial public offering.[16]

8. 17 C.F.R. § 229.303(a) (2019).
9. *Id.*
10. 84 Fed. Reg. at 12702 (to be codified at 17 C.F.R. § 229.303(a)).
11. *Id.*
12. *Id.* at 12677 (to be codified at 17 C.F.R. § 229.303(a)).
13. *Id.*
14. *Id.* at 12677 n.15 (to be codified at 17 C.F.R. § 229.303(a)).
15. *Id.*
16. *Id.*

The MD&A amendments eliminate the reference to discussion of the five-year selected financial data being needed when trend information is important.[17] Trend information is already required for a number of parts of MD&A, including liquidity and capital resources and results of operations.[18] Eliminating the requirement to also show five years of selected financial information was intended to eliminate duplication and focus companies on providing the trend disclosure in the MD&A.[19]

The amendments make conforming changes to the MD&A requirements for foreign private issuers contained in the instructions to Item 5 (Operating and Financial Review) of Form 20-F.[20] However, because the MD&A contained in Form 40-F, which is used by Canadian issuers, is prepared in accordance with applicable Canadian requirements, there are no corresponding revisions to that form.[21]

2. Confidential Portions of Exhibits

The SEC made several changes to Item 601 of Regulation S-K relating to confidential information contained in exhibits that are designed to streamline the confidential treatment process.[22] The amendments revise Item 601(b)(10) to permit registrants to omit confidential information from material contracts filed as exhibits without submitting a confidential treatment request ("CTR") to the SEC if such information is both not material and would likely cause competitive harm if disclosed.[23] A similar amendment was made to Item 601(b)(2) to allow redaction of immaterial provisions or terms in agreements relating to acquisitions, reorganizations, arrangements, liquidations, or successions that would likely cause competitive harm if publicly disclosed.[24] The SEC also expanded this type of redaction to certain exhibit-related requirements in specified disclosure forms for which Item 601(b)(10) does not apply, such as Form 20-F.[25] In addition, the amendments also made conforming changes to Item 1.01 of Form 8-K with respect to material contracts filed with that form.[26]

When relying on these provisions, registrants must:

- limit the redacted information to no more than necessary to prevent competitive harm;[27]

17. *Id.* at 12677 (to be codified at 17 C.F.R. § 229.303(a)).
18. 17 C.F.R. § 229.303(a)(1)–(3) (2019).
19. 84 Fed. Reg. at 12678 (to be codified at 17 C.F.R. § 229.3030(a)).
20. *Id.* at 12679 (to be codified at 17 C.F.R. § 229.303(a)).
21. *Id.* at 12679 n.43.
22. *Id.* at 12709 (to be codified at 17 C.F.R. § 229.601).
23. *Id.* at 12677 (to be codified at 17 C.F.R. § 229.601(b)(10)) (summarizing Regulation S-K, Items 601(b)(10) and 601(b)(2)).
24. *Id.* at 12681 (to be codified at 17 C.F.R. § 220.601(b)(2)).
25. *Id.* at 12682 (to be codified at 17 C.F.R. § 220.601(b)(10)).
26. *Id.* (to be codified at 17 C.F.R. § 220.601).
27. *Id.* at 12680.

- mark the exhibit index to indicate that portions have been omitted;[28]
- include a prominent statement on the first page of each redacted exhibit indicating that information in the marked sections of the exhibit has been omitted because it is both not material and would likely cause competitive harm to the company if publicly disclosed;[29] and
- indicate with brackets where the information has been omitted from the filed version of the exhibit.[30]

In addition, upon request of the SEC Staff, registrants are required to provide supplemental materials to the SEC Staff, including both an unredacted paper copy of the exhibit in question and an analysis of why the redacted information satisfies the test for non-disclosure.[31] Companies would be able to continue to use Rule 83 to request confidential treatment of supplemental information provided to the SEC Staff.[32]

If a company has a CTR pending on the effective date for the amended rules covering redaction of confidential information in material contracts, it may, but is not required to, withdraw its application.[33] The adopting release advises companies that opt to withdraw a pending request in such circumstances to refile redacted exhibits in accordance with the amendments.[34]

In addition, the SEC added a new paragraph (a)(5) of Item 601 of Regulation S-K to allow registrants to omit entire schedules and similar attachments to exhibits unless they contain material information that is not otherwise disclosed in the exhibit or the disclosure document.[35] A list briefly identifying the contents of omitted schedules must be contained in the exhibit and any omitted schedule would need to be submitted to the SEC Staff on a supplemental basis upon request.[36] The existing provision contained in Item 601(b)(2) of Regulation S-K, which permitted only the omission of schedules and attachments relating to plans of acquisition, reorganization, arrangement, liquidation, or succession, was deleted since the new paragraph (a)(5) now covers all exhibits filed under Item 601.[37]

The SEC also added a new paragraph (a)(6) of Item 601 of Regulation S-K that allows registrants to omit personally identifiable information from exhibits without submitting a CTR.[38]

28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.* at 12699.
34. *Id.*
35. *Id.* at 12704 (to be codified at 17 C.F.R. § 229.601(a)(5)).
36. *Id.*
37. *Id.* at 12691.
38. *Id.* (to be codified at 17 C.F.R. § 229.601(a)(6)).

3. Other Exhibit Amendments

Prior to the amendments, Item 601(b)(10) of Regulation S-K required material contracts to be filed not only when the contract must be performed in whole or in part at or after the filing of the registration statement or report but also when the contract was entered into not more than two years before the filing.[39] The amendments eliminate the two-year look-back for material contracts for all but newly reporting registrants.[40] Investors will continue to have access to previously filed material contracts through EDGAR.[41]

Item 601(b)(4)(vi) of Regulation S-K, setting forth exhibit requirements for instruments defining the rights of security holders, was amended to require registrants to provide an additional exhibit to Form 10-K containing the description required by Items 202(a)–(d) and (f) of Regulation S-K for each class of their securities that is registered under section 12 of the Securities Exchange Act of 1934, as amended (the "Exchange Act").[42] Previously, a description of securities had been required by Item 202 in registration statements, but not in Form 10-K or Form 10-Q.[43] The new requirement does not change existing disclosure obligations under Form 8-K or Schedule 14A, which require registrants to disclose certain modifications to the rights of their security holders and amendments to their charter or bylaws, or the current requirement to file a complete copy of the amended charter or bylaws.[44]

The amendments make conforming changes to the exhibit requirements for foreign private issuers in Form 20-F, which continues a longstanding attempt to conform the exhibit requirements for Form 20-F with the exhibit requirements for registration statements filed by domestic issuers.[45] However, the SEC did not make similar changes to Form 40-F.[46]

4. Property

The SEC has amended Item 102 of Regulation S-K to emphasize materiality by requiring disclosure of principal physical properties to the extent material to the registrant.[47] These disclosures may be provided on a collective basis if appropriate.[48] However, the amendments do not modify instructions to Item 102 that are specific to the oil and gas industry.[49]

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39. *Id.* at 12692 n.207.
40. *Id.* at 12692 (to be codified at 17 C.F.R. § 229.601).
41. *Id.*
42. *Id.* at 12690 (to be codified at 17 C.F.R. § 229.601(b)(4)(vi)).
43. *Id.*
44. *Id.*
45. *Id.* at 12693.
46. *Id.*
47. *Id.* at 12684 (to be codified at 17 C.F.R. § 229.102).
48. *Id.*
49. *Id.*

5. Section 16 Disclosure

The amendments revise Item 405 of Regulation S-K to clarify that registrants may rely on section 16 reports filed on EDGAR (as opposed to copies furnished to the registrant) to determine if there are any late filings.[50] Also, the heading for such disclosure is changed to "Delinquent Section 16(a) Reports" instead of "Section 16(a) Beneficial Ownership Reporting Compliance."[51] An instruction encourages this caption to be excluded if there are no delinquencies to report.[52] The amendments also eliminate the checkbox on the cover page of Form 10-K relating to late section 16 filing disclosure.[53]

6. Executive Officer Disclosure

The instructions to Item 401 of Regulation S-K have been revised to clarify that registrants do not need to duplicate executive officer disclosure under such item in their proxy statements if they have already provided it in Part I of their Form 10-K.[54] The prior location of the applicable instruction in Item 401(b) created uncertainty as to whether it covered those executive officer disclosures required by the other paragraphs of Item 401.[55] To reflect a "plain English" approach, the amendments change the caption for such disclosure to "Information about our Executive Officers."[56]

7. Registration Statement/Prospectus Requirements

The amendments modify Item 501 of Regulation S-K so that if the offering price will be determined by a particular method or formula, the description of the method or formula may be omitted from the prospectus cover page and be more fully explained in the prospectus.[57] This disclosure requires a cross-reference to the offering price method or formula disclosure, including a page number that is highlighted by prominent type or in another manner.[58]

Item 501 of Regulation S-K was amended to require the cover page of a prospectus to disclose the principal U.S. markets for the securities being offered and their corresponding trading symbols rather than limiting such information to listings on a national securities exchange.[59] The amendments limit disclosure relating to markets that are not national securities exchanges to those principal

50. *Id.* at 12686 (to be codified at 17 C.F.R. § 229.405).
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.* at 12685 (to be codified at 17 C.F.R. § 229.401).
55. *Id.*
56. *Id.*
57. *Id.* at 12718 (to be codified at 17 C.F.R. § 229.501).
58. *Id.* (Instruction 2 to 17 C.F.R. § 229.501(b)(3)).
59. *Id.*

U.S. markets where the registrant, through the engagement of a registered broker-dealer, had achieved quotation.[60]

The amendments also permit registrants to exclude the portion of the "Subject to Completion" legend relating to state law if the offering is not prohibited by state blue sky law.[61]

8. Risk Factors

The SEC's risk factor disclosure amendments reflect regulatory streamlining rather than any change in the principles-based requirement of risk factor disclosure. The amendments move the requirements for risk factor disclosure out of Item 503 of Regulation S-K into a new Item 105.[62] The SEC eliminated the specific examples of risk factors from Regulation S-K to encourage registrants to focus on their own risk identification process.[63]

9. Incorporation by Reference

Rule 12b-23(b) under the Exchange Act, which addresses incorporation by reference, has been amended to prohibit financial statements from incorporating by reference, or cross-referencing, information that is contained outside of the financial statements unless otherwise specifically permitted or required by the SEC's rules, U.S. generally accepted accounting principles ("U.S. GAAP"), or International Financial Reporting Standards, whichever is applicable.[64] According to the SEC, such incorporation by reference from outside the financial statements can raise questions as to the scope of an auditor's responsibilities.[65] On the other hand, the SEC did not change the ability of registrants to cross-reference to or incorporate information from the financial statements to satisfy the narrative disclosure requirements of Regulation S-K.[66]

The amendments eliminate provisions in Rule 12b-23 under the Exchange Act and Rule 411 of the Securities Act of 1933, as amended (the "Securities Act"), that had required information incorporated by reference to have been filed as an exhibit, with limited exceptions.[67] In addition, the amendments eliminate the requirement previously contained in Item 10(d) of Regulation S-K that generally prohibits registrants from incorporating documents by reference that have been on file with the SEC for more than five years.[68]

60. *Id.* at 12688.
61. *Id.*
62. *Id.* (to be codified at 17 C.F.R. § 229.105).
63. *Id.* at 12689.
64. *Id.* at 12683 (to be codified at 17 C.F.R. § 240.12b-23).
65. *Id.* at 12682.
66. *Id.* at 12682–83.
67. *Id.* at 12694.
68. *Id.* at 12693.

10. Additional Hyperlinks

Some of the disclosure modernization and simplification amendments require incorporation of technology developments. For example, the SEC already requires that the exhibit index of specified SEC filings be hyperlinked to the location of the relevant exhibit on EDGAR.[69] The amendments expand the use of hyperlinking by requiring registrants to provide hyperlinks to information that is incorporated by reference, whether or not the information is in a document filed as an exhibit, if that information is available on EDGAR.[70] Unlike the exhibit hyperlink requirement, a registrant is not required to correct inaccurate hyperlinks in an effective registration statement by including a corrected hyperlink in a subsequent periodic report or post-effective amendment.[71]

11. Exchange Act Filings

To further enhance investors' ability to use interactive data, the amendments provide that information on the cover pages of Forms 10-K, 10-Q, 8-K, 20-F, and 40-F will be required to be tagged in Inline Extensible Business Reporting Language ("XBRL"), HyperText Markup Language ("HTML") format with embedded XBRL data, subject to a transition period described below.[72] The Inline XBRL requirement is similar to a recent SEC rule change requiring Inline XBRL for operating company financial statements.[73] In addition, the amendments require the cover pages of Forms 10-K, 10-Q, 8-K, 20-F, and 40-F to include the trading symbol for each class of the registrant's registered securities.[74]

The requirements to tag data on the cover pages of certain filings are subject to a three-year phase-in.[75] Large accelerated filers that prepare their financial statements in accordance with U.S. GAAP need to comply with this tagging requirement in reports for fiscal periods ending on or after June 15, 2019.[76] Accelerated filers that prepare their financial statements in accordance with U.S. GAAP will need to comply with this requirement for reports for fiscal periods ending on or after June 15, 2020.[77] All other filers will need to comply for reports for fiscal periods ending on or after June 15, 2021.[78]

12. Updating Regulation S-K

The amendments eliminate a reference to an outdated auditing standard contained in Item 407(d) of Regulation S-K relating to audit committee discussions

69. 17 C.F.R. § 239.40 (2019).
70. 84 Fed. Reg. at 12694.
71. *Id.* at 12695.
72. *Id.* at 12699.
73. 17 C.F.R. § 232.405(b) (2019).
74. 84 Fed. Reg. at 12706.
75. *Id.* at 12699.
76. *Id.*
77. *Id.*
78. *Id.*

with independent auditors, replacing it with a general reference to the applicable requirements of the Public Company Accounting Oversight Board.[79] The amendments also update Item 407(e) to specifically exclude EGCs from the requirement to provide a compensation committee report because they are not required to provide a compensation discussion and analysis.[80] In addition, the SEC eliminated certain obsolete undertakings contained in Item 512 of Regulation S-K.[81]

B. Testing the Waters for All—New Rule 163B Expands TTW to All Issuers

On September 26, 2019, the SEC extended the ability to test the waters to all issuers by adopting Rule 163B under the Securities Act.[82] The new rule allows any issuer, or any person acting on the issuer's behalf, to engage in test the waters communications with potential investors that are reasonably believed to be institutional accredited investors ("IAIs") and qualified institutional buyers ("QIBs"), either prior to or following the date of filing of a registration statement relating to the offering, without violating the Securities Act's "gun jumping" rules.[83] Prior to Rule 163B, the ability to test the waters was limited to EGCs only.[84]

Since the Jumpstart Our Business Startups (the "JOBS Act") was enacted in 2012, EGCs have benefited from the opportunity to test the waters with institutional investors and gauge interest in a potential offering. Title I of the JOBS Act added section 5(d) to the Securities Act in order to provide that certain communications made by EGCs or persons acting on their behalf with IAIs and QIBs, either prior to or following the filing of a registration statement, would not constitute "gun jumping."[85]

Although most issuers that have undertaken initial public offerings in recent years are EGCs and already benefit from the ability to communicate with institutional investors, the notion of extending this communications safe harbor to other issuers has been viewed as providing greater flexibility without raising any investor protection concerns.

79. *Id.* at 12686 (to be codified at 17 C.F.R. § 229.407(d)).

80. *Id.* at 12687.

81. *Id.* at 12690.

82. Solicitations of Interest Prior to a Registered Public Offering, Securities Act, 84 Fed. Reg. 53011 (Oct. 4, 2019) (to be codified at 17 C.F.R. § 230.163B.

83. *Id.* at 53012.

84. Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts New Rule to Allow All Issuers to "Test-the-Waters" (Sept. 26, 2019), https://www.sec.gov/news/press-release/2019-188) ("The Securities and Exchange Commission today announced that it has voted to adopt a new rule that extends a 'test-the-waters' accommodation—currently a tool available to emerging growth companies or 'EGCs'—to all issuers.").

85. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, 311 (2012) (codified as amended at 15 U.S.C. § 77e(d) (2018)).

Under the new rule, these communications can be oral or written, are not required to be filed with the SEC, and are not required to bear any legends.[86] Since written communications are permitted, the SEC also amended Rule 405 in order to exclude written communications used in reliance on Rule 163B or section 5(d) of the Securities Act from the definition of "free writing prospectus."[87] Of course, information shared in any test the waters communication must not conflict with material information included in the registration statement for the offering. Although the SEC acknowledged that "circumstances or messaging" may change between the time a pre-filing Rule 163B communication is made and the time a registration statement is filed, statements made in any 163B communications must not contain material misstatements or omissions at the time such statements are made.[88]

Although similar to section 5(d) in many respects, unlike section 5(d), Rule 163B requires only a reasonable belief that the investors receiving communications are QIBs or IAIs rather than requiring that such investors in fact fall into those categories.[89] Neither Rule 163B nor the SEC's adopting release specifies the steps that could or must be taken to establish a reasonable belief regarding investor status. This approach is intended to provide issuers with flexibility to use cost-effective methods that are appropriate to the facts and circumstances.

The SEC's adopting release makes clear that while communications benefiting from Rule 163B do not violate the gun-jumping rules, such communications are "offers" under the Securities Act and thus are subject to liability under section 12(a)(2) under the Securities Act and other anti-fraud provisions such as Rule 10b-5 under the Exchange Act.[90]

The SEC confirmed that an issuer could test the waters without such communications constituting a general solicitation and, thus, preserve its ability to pursue a private placement in lieu of a registered offering even after testing the waters for a registered offering.[91] However, the SEC also cautioned that whether a test the waters communication would also be a general solicitation would depend on the facts and circumstances.[92]

The new rule is available to be relied upon by all issuers, including reporting and non-reporting companies, investment companies, such as closed-end funds, and business development companies.[93]

86. 84 Fed. Reg. at 53036.
87. *Id.* at 53035.
88. *Id.* at 53015–16.
89. *Id.* at 53036.
90. *Id.* at 53013.
91. *Id.* at 53016.
92. *Id.* ("In our view, whether a test-the-waters communication would constitute a general solicitation depends on the facts and circumstances regarding the manner in which the communication is conducted.").
93. *Id.* at 53016–17; *see id.* § II(B).

Accounting Developments 2019

In 2019, the Financial Accounting Standards Board (the "FASB") issued twelve Accounting Standards Updates ("ASUs") to its Accounting Standards Codification ("ASC" or the "Codification"), compared to twenty ASUs in 2018. Of the twelve 2019 ASUs, the FASB issued two ASUs that defer the effective dates of various amendments. It deferred the effective dates of three major updates, the ASUs related to the measurement of credit losses, hedging and leases,[1] and of amendments to the goodwill impairment test[2] and to the financial reporting requirements for long-duration contracts issued by insurance entities.[3] Five of the 2019 ASUs simplify, clarify, or make targeted improvements to the following standards: three standards or amendments to standards that were not yet effective for all entities, the standards relating to leases,[4] the measurement of credit losses,[5] and hedging;[6] and amendments related to debt and equity securities,[7] share-based payments,[8] and income taxes.[9] The FASB issued four ASUs that provide relief to not-for-profit entities with respect to the accounting treatment of goodwill,[10] update guidance applicable primarily to not-for-profit companies,[11] and conform the sections of the Codification to amendments adopted by the Securities and Exchange Commission ("SEC") to its financial reporting rules in Regulation S-X.[12] The FASB issued one ASU that articulates a consensus of the FASB's Emerging Issues Task Force (the "EITF")[13] and did not issue any ASUs that articulate a consensus of the FASB's Private Company Council (the "PCC").

The EITF, which was formed in 1984, seeks to address emerging accounting issues before divergent approaches to those issues become widespread.[14] The FASB must approve all consensuses reached by the EITF.[15] The EITF is chaired

1. *See infra* section A.9.
2. *See infra* section A.9.
3. *See infra* section A.8.
4. *See infra* section A.1.
5. *See infra* sections A.3, A.4, and A.10.
6. *See infra* section A.3.
7. *See infra* section A.3.
8. *See infra* section A.7.
9. *See infra* section A.11.
10. *See infra* section A.5.
11. *See infra* section A.2.
12. *See infra* section A.6.
13. *See infra* section B.1.
14. *Emerging Issues Task Force (EITF), About the EITF*, FIN. ACCT. STANDARDS BOARD, https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137512 (last visited Mar. 3, 2020).
15. *Id.*

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.[16]

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.[17] The FASB must endorse all consensuses reached by the PCC.[18] 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.[19] A 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 2019 that were not originated by the EITF and (b) the ASU that was originated by the EITF in 2019.

A. ASUS Originated by the FASB

1. Improvements to Lease Accounting Requirements

In March 2019, the FASB issued ASU No. 2019-01,[20] which addresses three issues brought to the FASB's attention by stakeholders about the new accounting standard for leases,[21] ASC Topic 842, Leases ("ASC 842"), included in ASU No. 2016-02.[22] These issues are ones that the FASB would typically address through its Codification Improvements project, which is an ongoing project to clarify accounting guidance or to correct unintended interpretations of guidance when such clarifications or corrections are not expected to significantly affect accounting practice or result in costly implementation activities.[23] The FASB decided to issue ASU 2019-01, rather than include the improvements in a comprehensive improvements ASU, to increase awareness of the amendments and expedite the improvements.[24]

16. *Id.*
17. *Private Company Council (PCC), History of Establishing the PCC*, Fin. Acct. Standards Board, https://www.fasb.org/pcc/history (last visited Mar. 3, 2020).
18. *Id.*
19. *Id.*
20. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-01, Leases (Topic 842): Codification Improvements (Mar. 2019) [hereinafter ASU 2019-01].
21. *Id.* at 1.
22. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-02, Leases (Topic 842) (Feb. 2016) [hereinafter ASU 2016-02].
23. ASU 2019-01, *supra* note 20, at 10.
24. *Id.*

The issues addressed in ASU 2019-01 are the following:

Issue 1: Fair Value Determination by Lessors That Are Not Manufacturers or Dealers[25]—Whereas the lease accounting requirements that are superseded by ASC 842 provide an explicit exception for lessors who are not manufacturers or dealers for determining fair value of the leased property, ASC 842 did not include that exception.[26] In ASU 2019-01, the FASB amended ASC 842 to provide that lessors who previously qualified for the exception in ASC Topic 840, Leases, ("ASC 840") the superseded guidance, generally financial institutions and captive finance companies, would have the same exception as under ASC 840.[27] Instead of valuing the asset underlying the lease at fair value, that is, the price that market participants would receive or pay in an orderly sale transaction, referred to as the "exit price," a lessor would be able to continue to value the asset at its cost, which reflects any volume or trade discounts that may apply, unless a significant amount of time has elapsed between the acquisition of the underlying asset and the lease commencement, in which case the exit price must be used.[28]

Issue 2: Cash Flow Treatment of Sales-Type and Direct Financing Leases by Depository and Lending Institution Lessees[29]—Whereas ASC 842 requires the presentation of cash receipts from leases within operating activities, ASC Topic 942, Financial Services—Depository and Lending ("ASC 942"), has an illustrative example that shows the presentation of principal payments received from leases under sales-type and direct financing leases within investing activities.[30] ASU 2019-01 eliminates the conflict by providing that lessors that are depository and lending institutions within the scope of ASC 942 must present all "principal payments received under leases" within investing activities.[31]

Issue 3: Transition Disclosures About Accounting Changes—ASC Topic 250-10-50, Accounting Changes and Error Corrections—Overall—Disclosure ("ASC 250-10-50"), requires various disclosures upon a change in accounting in both annual financial statements as well as interim periods.[32] ASC 842 exempts all lessees and lessors from providing the disclosures about accounting changes required by ASC 250-10-50-1(b)(2) in annual financial statements but does not explicitly exempt entities from providing those disclosures in interim financial statements.[33] ASU 2019-01 clarifies the FASB's original intent by explicitly providing an exception from the need for the disclosures required by ASC 250-10-50-1(b)(2) in interim period financial statements.[34]

25. *Id.* at 1.
26. *Id.* at 1–2.
27. *Id.* at 2.
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.* at 3.
33. *Id.*
34. *Id.*

ASU 2019-01 is effective with respect to the first two issues for financial statements of public business entities,[35] certain not-for-profit entities, and employee benefit plans that file financial statements with the SEC for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.[36] Other entities must comply with ASU 2019-01 in financial statements for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.[37] The transition disclosure requirement addressed in Issue 3 amends the original transition requirements in ASC 842. Early application of the amendments addressed in the first two issues is permitted for all entities and an entity should apply the amendments as of the date that it first applies ASC 842, using the same transition methodology, as required by ASC 842-10-65-1(c).

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35. 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 (last visited Mar. 2, 2020) (password protected) [hereinafter Master Glossary].

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 Topic 606, Revenue from Contracts with Customers ("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)).

36. ASU 2019-01, *supra* note 20, at 4.

37. *Id.* In November 2019, the FASB issued an ASU that defers the effective date of ASU 2016-02 for entities that were not required to comply with that new lease accounting standard. *See infra* section A.9.

2. Revision to and Clarification of Scope of Collections Guidance

In March 2019, the FASB issued ASU No. 2019-03,[38] which updates and conforms the definition of "collections" in the Codification to the updated definition adopted by the American Alliance of Museums ("AAM") for purposes of its Code of Ethics for Museums.[39] The FASB had used the term "collections" in Statement of Financial Accounting Standards No. 116, Accounting for Contributions Received and Contributions Made (June 1993) ("Statement 116"), which was issued prior to the update by the AAM.[40] In addition, ASU 2019-03 revises ASC Topic 360, Property, Plant, and Equipment, to clarify that the accounting and disclosure guidance for collections in ASC Subtopic 958-360, Not-for-Profit Entities—Property, Plan, and Equipment, applies to business entities as well as not-for-profit entities, consistent with Statement 116.[41] The amendments in ASU 2019-03 apply to all entities, including business entities, that maintain collections, although, generally, only not-for-profit entities need to account for collections.[42]

The amended definition of "collections" in the Master Glossary of the Codification expands the definition to provide that the proceeds from the sale of works of art, historical treasurers, or similar assets may be used for the direct care of existing collections as well as for the currently permitted acquisition of new collection items.[43] The amendments require an entity to disclose its policy for the use of proceeds from sold collection items and define what it means by the term "direct care."[44] The FASB believes that the new requirements will improve the disclosure to financial statement users of how the entity defines collections for purposes of capitalization.[45] In addition, it believes that the alignment of the definition and permitting proceeds to be utilized for the care of existing collections are consistent with the basis for the conclusion in Statement 116 about the care and preservation of collections, which was fundamental to the decision to permit entities to not recognize contributed collections.[46] Current GAAP states that a not-for-profit entity may account for its collection in any of three ways, by capitalization, capitalization of all collection items acquired after a stated date, and no capitalization.[47]

ASU 2018-03 is effective for financial statements of all entities for fiscal years beginning after December 15, 2019, and interim periods beginning after Decem-

38. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-03, Not-for-Profit Entities (Topic 958): Updating the Definition of "Collections" (Mar. 2019) [hereinafter ASU 2019-03].
39. *Id.* at 1.
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.* at 3.
44. *Id.* at 1.
45. *Id.* at 2.
46. *Id.*
47. *Id.*

ber 15, 2020.[48] Early adoption of the amendments is permitted.[49] The amendments should be applied on a prospective basis.[50]

3. Improvements to the Accounting for Financial Instruments, Credit Losses and Derivatives

In April 2019, the FASB issued ASU No. 2019-04,[51] which clarifies or corrects certain provisions adopted in[52] ASU No. 2016-01,[53] ASU No. 2016-13,[54] and ASU 2017-12,[55] which relate to financial instruments, credit losses, and derivatives, respectively. These clarifications and corrections are consistent with the FASB's ongoing project on its agenda to improve the Codification or correct its unintended application with respect to items that are not expected to have a significant effect on current accounting practice or to create a significant administrative cost for most entities.[56]

Financial Instruments—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.[57] ASU 2019-04 addresses issues arising from the amendments in ASU 2016-01 that stakeholders brought to the attention of the FASB.[58] The amendments, which are presented in Topic 4 in ASU 2019-04, are as follows:

- Issue 4A: Scope Clarifications—ASU 2019-04 clarifies the scope of ASC Subtopic 310-10, Investments—Debt Securities—Overall ("ASC 310-20"), and ASC Subtopic 321-10, Investments—Equity Securities—Overall ("ASC 321-10"), by stating that health and welfare plans are not within the scope of either ASC 310-20 or ASC 321-10.[59]

- Issue 4B: Held-to-Maturity Debt Securities Fair Value Disclosures—ASU 2019-04 clarifies that entities other than public business entities are

48. *Id.*
49. *Id.*
50. *Id.*
51. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments (Apr. 2019) [hereinafter ASU 2019-04].
52. *Id.* at 1.
53. 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].
54. 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].
55. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities (Aug. 2017) [hereinafter ASU 2017-12].
56. ASU 2019-04, *supra* note 51, at 1.
57. *Id.*
58. *Id.* at 13.
59. *Id.* at 13–14.

exempt from the fair value disclosure requirements for financial instruments that are not measured at fair value on the balance sheet in ASC 320-10 and ASC 942-320, Financial Services—Depository and Lending—Investments—Debt and Equity Securities.[60]

- Issue 4C: Applicability of ASC Topic 820, Fair Value Measurement ("ASC 820"), to the Measurement Alternative—ASU 2019-04 clarifies that an entity must remeasure the value of an equity security at fair value when it identifies an orderly transaction for an investment that is identical or is a similar investment of the same issuer even though the entity used the measurement alternative for that equity security because it initially determined that the equity security had no readily determinable fair value. The remeasurement must be in accordance with the provisions of ASC 820.[61]
- Issue 4D: Remeasurement of Equity Securities at Historical Exchange Rates—ASU 2019-04 clarifies that equity securities without readily determinable fair values accounted for under the measurement alternative are required to be remeasured using historical foreign currency exchange rates.[62]

Credit Loss Methodology—ASU 2016-13 requires the use of the expected credit losses methodology for the measurement of credit losses on financial assets measured at amortized cost basis in a new topic in the Codification, ASC Topic 326, Financial Instruments—Credit Losses ("ASC 326"), which replaces the incurred loss methodology.[63] In addition, ASU 2016-13 also modified the accounting for available-for-sale debt securities to require that credit losses on available-for-sale debt securities be presented as an allowance rather than as a write-down.[64] ASU 2019-04 amends ASC 326 to reflect issues discussed by the Credit Losses Transition Resource Group (TRG).[65] The amendments are as follows[66]:

- Topic 1: Codification Improvements Resulting from the June 11, 2018 and November 1, 2018 TRG Meetings
    - Issue 1A: Accrued Interest—ASU 2019-04 amends ASC Subtopic 326-20, Financial Instruments—Credit Losses—Measured at Amortized Cost ("ASC 326-20"), and ASC Subtopic 326-30, Financial Instruments—Credit Losses—Available-for-Sale Debt Securities ("ASC 326-30"), to permit an entity to:

60. *Id.* at 14.
61. *Id.* at 14–15.
62. *Id.* at 15.
63. *Id.* at 1.
64. ASU 2016-13, *supra* note 54, at 4.
65. ASU 2019-04, *supra* note 51, at 2.
66. *Id.* at 2, 5, and 16.

  - measure the allowance for credit losses on accrued interest receivable balances separately from other components of the amortized cost basis of associated financial assets;
  - make an accounting policy election not to measure an allowance for credit losses on accrued interest receivable amounts if it writes off the uncollectible accrued interest receivable balance in a timely manner and makes certain disclosures;
  - make an accounting policy election to write off accrued interest amounts by reversing interest income or recognizing credit loss expense, or a combination of both, and make certain disclosures;
  - make an accounting policy election to present accrued interest receivable balances and the related allowance for credit losses for those accrued interest receivable balances separately from the associated financial assets on the balance sheets related to accrued interest or, if not presented separately, disclose the amounts of the balances and the related allowance and where the balance is presented; and
  - elect a practical expedient to disclose separately the total amount of accrued interest included in the amortized cost basis as a single balance to meet certain disclosure requirements.[67]

- Issue 1B: Transfers between Classifications or Categories for Loans and Debt Securities—ASU 2019-04 amends ASC Subtopic 310-10, Receivables—Overall ("ASC 310-10"), ASC Subtopic 320-10, Investments—Debt Securities—Overall ("ASC 320-10"), ASC 326-20 and ASC Subtopic 948-310, Financial Services—Mortgage Banking—Receivables, to require that, upon a transfer of loans or debt securities between classifications or categories, an entity reverse in earnings any allowance for credit losses or valuation allowance previously measured on the loan or debt security, reclassify and transfer the loan or debt security to the new classification or category, and apply the applicable measurement guidance in accordance with the new classification or category.[68]
- Issue 1C: Recoveries—ASU 2019-04 amends ASC 326-20 and ASC 326-30 to clarify:
  - That an entity should include recoveries when estimating the allowance for credit losses;
  - That expected recoveries of amounts previously written off and expected to be written off should be included in the valuation account and should not exceed the aggregate of amounts previously written off and expected to be written off by the entity; and

67. *Id.* at 2–4.
68. *Id.* at 4.

    - That an allowance for credit losses that is added to the amortized cost basis of a collateral-dependent financial asset should not exceed amounts previously written off.[69]

- Topic 2: Codification Improvements to Update 2016-13

    - Issue 2A: Conforming Amendment When Foreclosure Is Probable on a Collateral Dependent Loan—ASU 2019-04 replaces an incorrect cross-reference in ASC Subtopic 310-40, Receivables—Troubled Debt Restructurings by Credits, with the correct cross-reference to require an entity to use the fair value of collateral to determine expected credit losses when foreclosure is probable.[70]

    - Issue 2B: Conforming Amendment Related to the Subsequent Measurement of Loans to and Debt Securities of an Equity Investee—ASU 2019-04 amends ASC Subtopic 323-10, Investments—Equity Method and Joint Ventures—Overall, to clarify the equity method losses allocation guidance by adding correct cross references to ASC 326.[71]

    - Issue 2C: Clarification That Reinsurance Recoverables Are within the Scope of Subtopic 326-20, Financial Instruments—Credit Losses—Measured at Amortized Cost ("ASC 326-20")—ASU 2019-04 amends ASC 326-20 to clarify that all reinsurance recoverables within the scope of ASC Topic 944, Financial Services—Insurance, are within the scope of ASC 326-20, regardless of the measurement basis of those recoverables.[72]

    - Issue 2D: Projections of Interest Rate Environments for Variable-Rate Financial Instruments—ASU 2019-04 amends ASC 326-20 and ASC 326-30 to remove the prohibition on using projections of future interest rate environments when using a discounted cash flow method to measure expected credit losses on variable-rate financial instruments as long as the entity uses the same assumptions in determining the effective interest rate used to discount those expected cash flows and adjusts the effective interest rate to consider timing (and changes in the timing) of expected cash flows resulting from expected prepayments.[73]

    - Issue 2E: Consideration of Prepayments in Determining the Effective Interest Rate—ASU 2019-04 amends ASC 326-20 and ASC 326-30 to permit an entity to make an accounting policy election to adjust the effective interest rate used to discount expected future cash

69. *Id.* at 5.
70. *Id.* at 5–6.
71. *Id.* at 6.
72. *Id.*
73. *Id.* at 7, 45.

flows for expected prepayments on financial assets within the scope of ASC 326-20 and on available-for-sale debt securities within the scope of ASC 326-30, except that no adjustment should be made for subsequent changes in expected prepayments if the financial asset is restructured in a troubled debt restructuring.[74]

  - Issue 2F: Consideration of Estimated Costs to Sell When Foreclosure Is Probable—ASU 2019-04 clarifies ASC 326-20-35-4 by specifically requiring that, when an entity determines that foreclosure on a financial asset is probable, it must consider the estimated costs to sell the collateral if it intends to sell rather than operate it.[75] In estimating the costs, ASU 2019-04 clarifies that the estimated costs to sell should not be discounted.[76]

- Topic 5: Codification Improvements Resulting from the Nov. 1, 2018 Credit Losses TRG Meeting
  - Issue 5A: Vintage Disclosures—Line-of-Credit Arrangements Converted to Term Loans—ASU 2019-04 requires an entity to present in a separate column within the vintage disclosure table the amortized cost basis of line-of-credit arrangements that are converted to term loans.[77]
  - Issue 5B: Contractual Extensions and Renewals—ASU 2019-04 requires an entity to consider extension or renewal options (excluding those that are accounted for as derivatives in accordance with ASC 815, Derivatives and Hedging ("ASC 815")) that are included in the original or modified contract at the reporting date and are not unconditionally cancellable by the entity.[78]

Hedge Accounting—ASU 2017-12 made targeted improvements to the hedge accounting model intended to better portray the economic results of an entity's risk management activities in its financial statements and to simplify the application of hedge accounting guidance.[79] ASU 2019-04 relates to some of the items in ASU 2017-02 as well as other aspects of hedge accounting requirements.[80] The amendments, which are presented in Topic 3 in ASU 2019-04, are as follows:

- Issue 3A: Partial-Term Fair Value Hedges of Interest Rate Risk—ASU 2019-04 clarifies that an entity may measure the change in the fair value of a hedged item using an assumed term only for changes attributable to

74. *Id.* at 7–8.
75. *Id.* at 8.
76. *Id.*
77. *Id.* at 16.
78. *Id.*
79. *Id.* at 2.
80. *Id.* at 9.

interest rate risk.[81] In addition, it clarifies that an entity may measure the change in the fair value of a hedged item attributable to interest rate risk using an assumed term when the hedged item is designated in a hedge of both interest rate risk and foreign exchange risk.[82] Finally, it clarifies that one or more separately designated partial-term fair value hedging relationships of a single financial instrument can be outstanding at the same time and that the issuance of a forward-starting partial-term fair value hedge is assumed to occur on the date on which the first hedged cash flow begins to accrue.[83]

- Issue 3B: Amortization of Fair Value Hedge Basis Adjustments—ASU 2019-04 permits an entity to begin to amortize a fair value hedge basis adjustment before the fair value hedging relationship is discontinued.[84] In addition, it clarifies that, if an entity elects to begin amortizing the basis adjustment during an outstanding partial-term hedge, it must fully amortize the basis adjustment by the hedged item's assumed maturity date.[85]
- Issue 3C: Disclosure of Fair Value Hedge Basis Adjustments—ASU 2019-04 clarifies that an entity should disclose available-for-sale debt securities at their amortized cost and should exclude fair value hedge basis adjustments related to foreign exchange risk from the disclosures required by ASC 815-10-50-4EE.[86]
- Issue 3D: Consideration of the Hedged Contractually Specified Interest Rate under the Hypothetical Derivative Method—ASU 2019-04 clarifies that an entity should consider the contractually specified interest rate being hedged when applying the hypothetical derivative method.[87]
- Issue 3E: Scope for Not-for-Profit Entities—ASU 2019-04 clarifies that an entity that does not report earnings separately, such as not-for-profit entities, may not use cash flow hedge accounting as described in ASC Subtopic 815-20, Derivative and Hedging—Hedging—General, and may not elect the amortization approach for amounts excluded from the assessment of effectiveness for fair value hedging relationships.[88]
- Issue 3F: Hedge Accounting Provisions Applicable to Certain Private Companies and Not-for-Profit Entities—ASU 2019-04 clarifies that a private company that is not a financial institution, as described in ASC Subtopic 942-320-50-1, Financial Services—Depository and Lending—

81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.* at 10.
85. *Id.*
86. *Id.*
87. *Id.*
88. *Id.* at 11, 57.

Investments—Debt and Equity Securities—Disclosure, should document the analysis underlying a last-of-layer hedge designation concurrently with hedge inception.[89] In addition, it identifies the types of not-for-profit entities that qualify for the same relief from the subsequent quarterly hedge effectiveness assessment for which certain private companies qualify under ASC 815-20-25-142, Derivatives and Hedging—Hedging—General—Recognition—Hedge Effectiveness Assessments.[90]

- Issue 3G: Application of a First-Payments-Received Cash Flow Hedging Technique to Overall Cash Flows on a Group of Variable Interest Payments—ASU 2019-04 clarifies that the first-payments-received cash flow hedging technique continues to be permitted for changes in overall cash flows on a group of variable interest payments.[91]
- Issue 3H: Update 2017-12 Transition Guidance—ASU 2019-04 clarifies the transition guidance in ASU 2017-12.[92]

ASU 2019-04 has different effective dates for the three different topics. The amendments of ASU 2016-01 relating to financial instruments, which are in Topic 4, are effective for financial statements for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.[93] The amendments should be applied on a modified-retrospective transition basis by means of a cumulative-effect adjustment to the opening retained earnings as of the date an entity adopts all of the amendments in ASU 2016-01, except that the amendments related to equity securities without readily determinable fair values for which an entity elects the measurement alternative in ASC 321-10-35-2 should be applied prospectively.[94]

The amendments of ASU 2016-13 relating to credit losses, which are in Topics 1, 2, and 5, are effective for entities that have not yet adopted the amendments in ASU 2016-13 as of the issuance date of ASU 2019-04 at the same time as ASU 2016-13 is effective.[95] The transition requirements related to those amendments, including with respect to adjustments related to the determination of the uncollectibility and write off of accrued interest receivables, are the same as those in ASU 2016-13.[96]

89. *Id.* at 11.
90. *Id.*
91. *Id.* at 11–12.
92. *Id.* at 12–13.
93. *Id.* at 18.
94. *Id.* at 18–19.
95. *Id.* at 17. ASU 2016-13 is effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. ASU 2016-13, *supra* note 54, at 5. The FASB has deferred the effective dates of other entities in Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-10, Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates (Nov. 2019) [hereinafter ASU 2019-10]. *See infra* section A.9.
96. ASU 2019-04, *supra* note 51, at 17.

For entities that have adopted ASU 2016-013, the amendments in ASU 2019-04 are effective for financial statements for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, with early adoption permitted.[97] The amendments should be applied on a modified-retrospective basis by means of a cumulative-effect adjustment to the opening retained earnings balance as of the date the entity adopted ASU 2016-13.[98] The transition adjustment includes adjustments made relating to the determination of the uncollectibility and write off of accrued interest receivables.[99]

The amendments of ASU 2017-12 relating to hedging are effective for financial statements of entities that have not yet adopted ASU 2017-12 as of the issuance date of ASU 2019-04 on the same effective dates and using the same transition requirements as for the amendments in ASU 2017-12.[100] For entities that have adopted ASU 2017-12, the amendments are effective as of the beginning of the first annual period beginning after April 25, 2019, the issuance date of ASU 2019-04, with early adoption permitted.[101] An entity may elect to adopt the amendments retrospectively as of the date the entity adopted the amendments in ASU 2017-12 or prospectively as of the date of adoption of the amendments in ASU 2019-04 except that an entity:

(1) Must reflect any cumulative basis adjustment at the initial application date rather than the date of adoption if it adopted ASU 2017-12 during an interim period and elected to modify the measurement methodology for a fair value hedge of interest rate risk without dedesignating the hedge relationship.[102]

(2) Must reflect any adjustments for existing hedges as of the date of adoption of the amendments in ASU 2017-12 on the date of initial application of ASU 2017-12 if it elected to rebalance fair value hedging relationships upon adoption of the amendments in ASU 2019-04.[103]

(3) Must reflect the reclassification as of the date of adoption of ASU 2019-04 if the entity did not reclassify debt securities from held-to-maturity to available-for-sale upon adoption of the amendments in ASU 2017-12 and elects to reclassify debt securities upon adoption of the amendments in ASU 2019-04, but an entity that reclassified debt securities from held-to-maturity to available-for-sale upon adoption of

97. *Id.*
98. *Id.*
99. *Id.*
100. ASU 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. ASU 2017-12, *supra* note 54, at 7. The FASB has deferred the effective date for other entities in ASU 2019-10. ASU 2019-10, *supra* note 95. *See infra* section A.9.
101. ASU 2019-04, *supra* note 51, at 18.
102. *Id.* at 18, 63.
103. *Id.* at 18.

the amendments to ASU 2017-02 is not permitted to make any additional reclassifications.[104]

4. Credit Losses—Targeted Transition Relief

In May 2019, the FASB issued ASU No. 2019-05[105] to address stakeholders' concerns that their election of the fair value option for newly originated or purchased financial assets pursuant to ASC 825-10, Financial Instruments—Overall, would result in financial statement information that would not be comparable because of the entities' historic use of amortized cost basis for identical or similar financial instruments.[106] ASU 2019-05 addresses those concerns by permitting entities to irrevocably elect the fair value option for certain financial assets previously measured at amortized cost basis, other than held-to-maturity debt securities.[107] This option to align measurement methodologies for similar financial assets is intended to increase comparability of financial statement information and decrease preparers' costs while still providing financial statement users with decision-useful information.[108]

ASU 2019-05 is effective for entities that have not yet adopted ASU 2016-13[109] on the same applicable effective dates as ASU 2016-13 and with the same transition methodology.[110] For entities that have adopted ASU 2016-13, ASU 2019-05 is effective for financial statements for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years, with early adoption permitted.[111] The amendments should be applied on a modified-retrospective basis by means of a cumulative-effect adjustment to the opening balance of retained earnings as of the date that the entity adopts the amendments in ASU 2016-13.[112]

5. Accounting by Not-for-Profit Entities for Goodwill and Other Intangibles

In May 2019, the FASB issued ASU No. 2019-06[113] to extend to not-for-profit entities the alternatives provided to private companies in two updates issued by

104. *Id.*

105. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-05, Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief (May 2019) [hereinafter ASU 2019-05].

106. *Id.* at 1.

107. *Id.* at 2.

108. *Id.*

109. *See infra* section A.9, which discusses the revised effective dates of ASU 2016-13.

110. ASU 2019-05, *supra* note 105, at 1.

111. *Id.* at 3.

112. *Id.*

113. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-06, Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities (May 2019) [hereinafter ASU 2019-06].

the FASB in 2014 relating to the accounting for goodwill and identifiable intangible assets in a business combination.[114] These 2014 updates are ASU No. 2014-02[115] and ASU No. 2014-18.[116] ASU 2014-02 amended ASC Topic 350 to simplify the accounting for goodwill by permitting all entities except for public business entities and not-for-profit entities, as defined in the Master Glossary,[117] to elect to amortize goodwill on a straight-line basis over ten years or less if a lower useful life is more appropriate.[118] ASU No. 2014-18 amended ASC Topic 805 to simplify the accounting for identifiable intangible assets acquired in an acquisition by permitting all entities, except for public business entities and not-for-profit entities, to elect to no longer recognize separately from goodwill certain customer-related intangible assets and non-competition agreements, provided that they also elect to amortize goodwill over its useful life pursuant to the relief in ASU 2014-02.[119]

In adopting ASU 2014-02 and ASU 2014-18, the FASB acknowledged that not-for-profit entities and public business entities might have the same concerns about the cost and complexity of the goodwill impairment test and the accounting for certain identifiable intangible assets, among other issues, as private companies and, as a result, added these topics to its agenda.[120] The amendments adopted in ASU 2019-06 extend the scope of the alternatives in ASU 2014-02 and ASU 2014-18 to not-for-profit entities, but do not change the guidance in the alternatives.[121] The amendments are intended to reduce the cost and complexity associated with preparers' subsequent accounting for goodwill and the measurement of certain identifiable intangible assets acquired without significantly diminishing the usefulness of the information for decision-making by users of not-for-profit entities.[122] The FASB has a separate project to consider the subsequent accounting for goodwill and the accounting for identifiable assets

114. *Id.* at 1.

115. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-02, Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill, a Consensus of the Private Company Council (Jan. 2014) [hereinafter ASU 2014-02].

116. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-18, Business Combinations (Topic 905): Accounting for Identifiable Intangible Assets in a Business Combination, a Consensus of the Private Company Council (Dec. 2014) [hereinafter ASU 2014-18].

117. The Master Glossary defines "not-for-profit entity," in part, as "[a]n entity that possesses the following characteristics, in varying forms . . . :

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return

b. Operating purposes other than to provide goods or services at a profit

c. Absence of ownership interests like those of business entities.

Master Glossary.

118. ASU 2014-02, *supra* note 115, at 2.

119. ASU 2014-18, *supra* note 116, at 2.

120. ASU 2019-06, *supra* note 113, at 1.

121. *Id.* at 2.

122. *Id.* at 1.

and it could determine that any amendments adopted as a part of that project should apply to not-for-profit entities as well.[123]

A not-for-profit entity that elects to amortize goodwill on a straight-line basis over ten years, or such shorter period that it demonstrates is more appropriate, in accordance with Topic 350, would be subject to all of the related subsequent measurement, derecognition, other presentation matters and disclosure requirements of this accounting alternative.[124] In addition, an entity that elects this accounting alternative must elect whether to test goodwill for impairment at the entity level or the reporting unit level.[125]

A not-for-profit entity that elects the accounting alternative in ASC Topic 805 would include within goodwill all customer-related intangible assets that are not capable of being sold or licensed independently from the other assets of a business and all noncompetition agreements acquired.[126] An entity that elects this alternative must apply the alternative to all transactions entered into after the effective date.[127] The accounting alternative applies to the recognition of the fair value of intangible assets as a result of any of the following transactions: acquisitions, business combinations, equity investments, and fresh start accounting.[128] An entity that elects this accounting alternative must also adopt the accounting alternative in ASC Topic 350 to amortize goodwill.[129]

ASU 2019-06 is effective upon issuance of the update.[130] Not-for-profit entities that elect to adopt the alternatives do not have to demonstrate the preferability of the alternatives.[131] The transition guidance and the open-ended effective date and unconditional one-time election that applied to private companies electing the accounting alternatives apply to non-for-profit entities that adopt the accounting alternatives.[132]

6. Updates to SEC Sections in the Codification

In July 2019, the FASB issued ASU No. 2019-07[133] to conform the sections of Regulation S-X included in the Codification to the amendments to Regulation S-X that the SEC adopted in SEC Final Rule Releases No. 33-10532, *Disclosure Update and Simplification*, and Nos. 33-10231 and 33-10442, *Investment Company*

123. *Id.*
124. *Id.* at 2.
125. *Id.*
126. *Id.* at 2–3.
127. *Id.* at 2.
128. *Id.*
129. *Id.* at 3.
130. *Id.* at 4.
131. *Id.*
132. *Id.*
133. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-07, Codification Updates to SEC Sections—Amendments to SEC Paragraphs Pursuant to SEC Final Rule Releases No. 33-10532, *Disclosure Update and Simplification*, and Nos. 33-10231 and 33-10442, *Investment Company Reporting Modernization*, and Miscellaneous Updates (July 2019) [hereinafter ASU 2019-07].

Reporting Modernization.[134] The SEC adopted these amendments to Regulation S-X in August 2018,[135] December 2017[136] and October 2016.[137]

7. Measurement of Share-based Payment Transactions with Nonemployees

In November 2019, the FASB issued ASU No. 2019-08,[138] which addresses feedback that the FASB received relating to likely diversity in practice resulting from the lack of guidance in ASU No. 2018-07[139] on the measurement of share-based payment awards granted to a customer.[140] The diversity could result from the measurement of share-based awards at either the inception of the contract under ASC Topic 606 or at the grant date under ASC Topic 718, Compensation—Stock Compensation ("ASC 718").[141] The FASB had issued ASU 2018-07 as a part of its Simplification Initiative, which is intended to identify, evaluate, and improve accounting guidance when costs and complexity can be reduced while maintaining or improving the usefulness of financial information for investors.[142] The FASB's project is intended to identify the amendments that are not expected to have a significant effect on current accounting practice or result in significant administrative costs for most entities.[143] In ASU 2018-07, the FASB had amended the Codification to require that share-based payment awards granted to a customer in connection with the sale of goods or services be accounted for under ASC Topic 606.[144]

ASU 2019-08 requires an entity to measure and classify share-based payment awards granted to a customer under the guidance in ASC Topic 718.[145] Therefore, all share-based payment awards granted to a customer must be measured based upon the grant-date fair value of the award in accordance with ASC 718,

134. *Id.* at 1.

135. Securities Act Release No. 10432, Disclosure Update and Simplification (Aug. 17, 2018), https://www.sec.gov/rules/final/2018/33-10532.pdf.

136. Securities Act Release No. 10442, Investment Company Reporting Modernization (Dec. 8, 2017), https://www.sec.gov/rules/final/2017/33-10442.pdf; Securities Act Release No. 10231, Investment Company Reporting Modernization (Oct. 13, 2016), https://www.sec.gov/rules/final/2016/33-10231.pdf.

137. Securities Act Release No. 10231, Investment Company Reporting Modernization (Oct. 13, 2016), https://www.sec.gov/rules/final/2016/33-10231.pdf.

138. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-08, Compensation—Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Codification Improvements—Share-Based Consideration Payable to a Customer (Nov. 2019) [hereinafter ASU 2019-08].

139. 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].

140. ASU 2019-08, *supra* note 138, at 1.

141. *Id.* at 1.

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.* at 2.

and the grant-date fair value must be recorded as a reduction to the transaction price.[146] The grant date is the date at which a supplier and a customer reach a mutual understanding of the key terms and conditions of a share-based payment ward.[147] If the recipient of the award ceases being a customer, the classification and subsequent measurement of the award is no longer subject to ASC Topic 718.[148] The FASB stated in a press release that the measurement and classification of share-based payment awards to customers under ASC 718 results in the following three improvements: (1) fewer measurement dates for the awards; (2) fewer instances of classifying the awards as liabilities; and (3) more consistent accounting with share-based payment awards made to other nonemployees.[149]

ASU 2019-08 is effective for financial statements of public business entities that have not yet adopted the amendments in ASU 2018-07 for fiscal years beginning after December 15, 2019, 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.[150] Early adoption is permitted, as long as the entity has already adopted ASU 2018-07.[151]

An entity may adopt ASU 2019-08 either in the same fiscal year in which it adopts the amendments in ASU 2018-07, in which case it would record a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the year in which it adopts ASU 2018-07, or in a fiscal year after the fiscal year in which the entity adopts ASU 2018-07, in which case it would record a cumulative effect adjustment to the opening balance of retained earnings at the beginning of either the fiscal year in which it adopts ASU 2018-07 or the fiscal year in which it adopts ASU 2019-08.[152]

For entities that have adopted ASU 2018-07, the amendments in ASU 2019-08 are effective for financial statements for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.[153]

8. Insurance

In November 2019, the FASB issued ASU No. 2019-09,[154] which defers the effective date of the amendments in ASU No. 2018-12[155] in response to a

146. *Id.*
147. *Id.*
148. *Id.*
149. Press Release, Fin. Accounting Standards Bd., FASB Improves Accounting for Share-Based Payments Made to Customers (Nov. 11, 2019), https://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176173712398&pagename=FASB%2FFASBContent_C%2FNewsPage.
150. *Id.*
151. *Id.*
152. *Id.* at 3.
153. *Id.*
154. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-09, Financial Services—Insurance (Topic 944): Effective Date (Nov. 2019) [hereinafter ASU 2019-09].
155. 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].

request for such a deferral.[156] The staggered effective dates for compliance with ASU 2018-12, which the FASB announced in ASU 2019-12, implements the FASB's new philosophy to provide different effective dates for larger public companies and for other companies.[157]

The FASB first considered its new philosophy for the effective dates of its standards in connection with its deferral of the effective dates of the new standards relating to credit losses, derivatives and hedging, and leases.[158] Under this philosophy, a major accounting change would be effective first for public business entities that are SEC filers, as both of those terms are defined in the FASB's Master Glossary,[159] with the exception of those companies that are eligible to be smaller reporting companies, as defined by the SEC.[160] The FASB expects to require all other entities, which include smaller reporting companies, to comply with a new major accounting change at least two years after the effective date for the first group of entities.[161]

ASU 2019-09 provides that public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies, as defined by the SEC, must comply with ASU 2018-12 for financial statements for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years.[162] ASU 2019-09 provides that all other entities, including entities that met the SEC's definition of smaller reporting company as of November 15, 2019, must comply with ASU 2018-12 for financial statements for fiscal years beginning after December 15, 2023, and interim periods within fiscal years beginning after December 15, 2024.[163] Early adoption of ASU 2018-12 is permitted.[164]

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156. ASU 2019-09, *supra* note 154, at 1.
157. *Id.*
158. *See* ASU 2019-10, *supra* note 96, at 1.
159. See *supra* note 35, for the definition of "public business entity." "SEC filer" is defined in the *Master Glossary* as follows:

> An entity that is required to file or furnish its financial statements with either of the following:
>
> a. The Securities and Exchange Commission (SEC)
>
> b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.
>
> Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.

160. ASU 2019-10, *supra* note 95, at 1. The SEC's definition of smaller reporting companies is set forth in Rule 205 in the General Rules and Regulations under the Securities Act of 1933, as amended, 17 C.F.R. 230.405, and Rule 12-2 in the General Rules and Regulations under the Securities Exchange Act of 1934, as amended. In general, a smaller reporting company is an entity that either had a public float of less than $250 million or had annual revenues of less than $100 million and no float or a public float of less than $700 million, based upon the float on the last business day of the entity's most recently completed second fiscal quarter, and revenues for the year that ended prior to that quarter.
161. ASU 2019-10, *supra* note 95, at 1.
162. *Id.*
163. *Id.* at 2.
164. *Id.*

9. Deferral of Effective Dates of Standards Related to Credit Losses, Derivatives and Hedging, and Leases

In November 2019, the FASB issued ASU 2019-10, which announces the deferral of the effective dates of its standards related to the expected credit loss model ("CECL"),[165] derivatives and hedging,[166] and leases[167] in connection with the FASB's adoption of a new philosophy to extend and simplify how effective dates are staggered between larger public companies (which the FASB places in "bucket one") and all other entities (which the FASB places in "bucket two").[168] As noted earlier,[169] the effective date of a major accounting change applicable to entities in bucket one, that is, public business entities that are SEC filers, excluding entities eligible to be smaller reporting companies under the SEC's definition, would be at least two years earlier than the effective date of such major accounting change applicable to entities in bucket two, which include private companies, smaller public companies, as defined by the SEC, not-for-profit organizations, and employee benefit plans.[170] With respect to future ASUs, a public business entity that is an SEC filer, as defined by the FASB, will determine whether it is a smaller reporting company based on whether the entity meets the definition of smaller reporting company at the time that such future ASU is issued.[171] With respect to existing accounting standards that are not yet effective, an entity will be considered a smaller reporting company if it meets the SEC's definition of smaller reporting company as of November 15, 2019.[172]

ASU 2019-10 implements the new effective date philosophy with respect to three major accounting standards and a related amendment to a standard that are not effective for all entities, as set forth below:

(1) ASU 2016-13—ASU 2016-13, which requires entities to evaluate the impairment of financial assets using an expected credit loss model ("CECL") rather than the probable, incurred loss model, is not yet effective for any entities.[173] ASU 2019-10 does not defer the effective date applicable to public business entities that meet the definition of an SEC filer and do not meet the definition of smaller reporting company.[174] The effective date applicable to these entities, which are in bucket one, is for financial

165. *See* ASU 2016-13, *supra* note 54.
166. *See* ASU 2017-12, *supra* note 55.
167. *See* ASU 2016-02, *supra* note 22.
168. ASU 2019-10, *supra* note 95, at 1.
169. *See* text at *supra* notes 159–61.
170. ASU 2019-10, *supra* note 95, at 1.
171. *Id.* at 2.
172. *Id.* at 1–2.
173. *Id.* at 1.
174. *Id.* at 1–2.

statements for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.[175]

ASU 2019-10 does defer the effective date of ASU 2016-13 applicable to all other entities, which are those entities in bucket two and include smaller reporting companies.[176] These entities must comply with ASU 2016-13 in financial statements for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.[177]

(2) ASU No. 2017-04[178]—ASU 2017-04, which eliminates Step 2 from the goodwill impairment test, has effective dates intended to align with the mandatory effective dates of ASU 2016-13.[179] To maintain that alignment, ASU 2019-10 defers the effective dates of ASU 2017-04 to be consistent with the mandatory effective dates of ASU 2016-13 that were deferred in ASU 2019-10, discussed above.[180]

(3) ASU 2017-12—ASU 2017-12, which relates to hedging, is effective for all public business entities, including smaller reporting companies, as defined by the SEC.[181] Accordingly, ASU 2019-10 defers the effective date only for entities other than public business entities.[182] ASU 2019-10 provides that ASU 2017-12 is effective for entities other than public business entities for financial statements for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.[183]

(4) ASU 2016-02—ASU 2016-02, which relates to leases, is effective for all public business entities, including smaller reporting companies, as well as not-for-profit entities that have issued or are conduct bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market and employee benefit plans that file or furnish financial statements with or to the SEC.[184] ASU 2019-10 defers the effective date for all other entities to financial statements for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.[185]

175. *Id.* at 2.
176. *Id.* at 1–2.
177. *Id.* at 2.
178. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-04, Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment (Jan. 2017) [hereinafter ASU 2017-04].
179. ASU 2019-10, *supra* note 95, at 3.
180. *Id.*
181. *Id.*
182. *Id.*
183. *Id.*
184. *Id.* at 4.
185. *Id.*

10. Credit Losses

In November 2019, the FASB issued ASU No. 2019-11,[186] which amends the Codification to make a variety of improvements to ASU No. 2016-13.[187] ASU 2016-13 requires entities to evaluate the impairment of financial assets using CECL, the expected credit loss model.[188] The FASB adopted the amendments in ASU 2019-11 in connection with its ongoing project to improve the Codification or correct unintended applications of accounting guidance but determined to issue a separate update to increase awareness of the improvements.[189] The amendments include items that stakeholders had raised.[190]

The amendments clarify or improve the Codification or correct errors in the Codification.[191] The amendments relate to the following five topics[192]:

(1) Expected Recoveries for Purchased Financial Assets with Credit Deterioration—The amendments clarify that the guidance related to the inclusion within the allowance for credit losses valuation account of expected recoveries of amounts previously written off or expected to be written off applies to purchased financial assets with credit deterioration.[193] In addition, it clarifies that the amount of the write off should not exceed the aggregate amounts previously written off or expected to be written off and that recoveries may include increases in expected cash flows after acquisition but should not include any amounts that result in an acceleration of the noncredit discount when a method other than a discounted cash flow method is used to estimate credit losses.[194]

(2) Transition Relief for Troubled Debt Restructurings—The amendments permit an entity to made an accounting policy election to adjust the effective interest rate on existing troubled debt restructurings using prepayment assumptions on the date of adoption of CECL rather than the prepayment assumptions in effect immediately before the restructuring.[195]

(3) Disclosure Related to Accrued Interest Receivables—The amendments extend the relief provided to entities related to certain disclosure about accrued interest included in the amortized cost basis to all disclo-

186. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-11, Codification Improvements to Topic 326, Financial Instruments—Credit Losses (Nov. 2019) [hereinafter ASU 2019-11].
187. *Id.* at 1.
188. *Id.*
189. *Id.*
190. *Id.*
191. *Id.* at 5.
192. *Id.* at 2–4.
193. *Id.* at 2.
194. *Id.*
195. *Id.* at 2–3.

sure requirements related to accrued interest included in the amortized cost basis.[196]

(4) Financial Assets Secured by Collateral Maintenance Provisions—The amendments clarify that, in applying the relief related to the estimate of expected credit losses related to financial assets secured by collateral maintenance provisions, an entity must assess whether it reasonably expects the borrower to replenish the collateral securing the financial assets.[197] In addition, in applying the relief, an entity must estimate expected credit losses for any amount of the amortized cost basis of a secured financial asset that exceeds the fair value of the collateral securing the asset and may assume that the there is no expectation of nonpayment for the amount of the amortized cost basis equal to the fair value of such collateral.[198]

(5) Conforming Amendment to Subtopic 805-20, Business Combinations—Identifiable Assets and Liabilities and Any Noncontrolling Interest—The amendments correct a superseded reference in ASC 805-20-50-1.[199]

ASU 2019-11 is effective for financial statements of public business entities that have not yet adopted the amendments in ASU 2016-13 at the time that ASU 2016-13 is effective.[200]

For entities that have adopted ASU 2016-13, the amendments in ASU 2019-11 are effective for financial statements for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.[201] The amendments should be applied on a modified retrospective basis by means of a cumulative-effect adjustment to the opening retained earnings balance in the statement of financial position as of the date of adoption of ASU 2016-13.[202] Early adoption is permitted in any interim period as long as the entity as adopted the amendments in ASU 2015-13.[203]

11. Income Taxes

In December 2019, the FASB issued ASU No. 2019-12,[204] which simplifies the accounting standards for income taxes as a part of its Simplification Initiative, which is intended to reduce complexity in accounting standards.[205] The amend-

196. *Id.* at 3.
197. *Id.* at 4.
198. *Id.*
199. *Id.*
200. *Id.* at 5.
201. *Id.*
202. *Id.*
203. *Id.*
204. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-12, Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes (Dec. 2019) [hereinafter ASU 2019-12].
205. *Id.* at 1.

ments in ASU 2019-12 are intended to reduce complexity by removing certain exceptions and clarifying and amending certain guidance.[206]

The amendments remove the following exceptions:

(1) The exception to the incremental approach for intraperiod tax allocation when there is a loss from continuing operations and income or a gain from other items.[207]

(2) The exception to the requirement to recognize a deferred tax liability for equity method investments when a foreign subsidiary becomes an equity method investment.[208]

(3) The exception to the ability not to recognize a deferred tax liability for a foreign subsidiary when a foreign equity method investment becomes a subsidiary.[209]

(4) The exception to the general methodology for calculating income taxes in an interim period when a year-do-date loss exceeds the anticipated loss for the year.[210]

The following amendments are intended to simplify the accounting for income taxes:

(1) Require an entity to recognize a franchise or similar tax that is partially based on income as an income-based tax and account for any incremental amount incurred as a non-income-based tax.[211]

(2) Require an entity to evaluate when a step up in the tax basis of goodwill should be considered part of the business combination in which the book goodwill was originally recognized or a separate transaction.[212]

(3) Specify that an entity is not required to allocate the consolidated amount of current and deferred tax expense to the separate financial statements of a legal entity that is not subject to tax.[213]

(4) Require an entity to reflect the effect of an enacted change in tax laws or tax rates in the annual effective tax rate disclosed in the interim period in which the tax change or rate is effective.[214]

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206. *Id.* at 1–2.
207. *Id.* at 1.
208. *Id.*
209. *Id.*
210. *Id.*
211. *Id.*
212. *Id.* at 2.
213. *Id.*
214. *Id.*

(5) Make minor improvements related to the determination of income taxes related to employee stock ownership plans and investments in qualified affordable housing projects accounted for using the equity method.[215]

The amendments are effective for public business entities for financial statements for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020.[216] The amendments are effective for all other entities 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 as long as the financial statements have not been issued or made available for issuance but an entity must adopt all of the amendments at the same time.[218] ASU 2019-12 provides that the amendments should be applied on a prospective basis except that the retrospective basis should be used for separate financial statements of legal entities not subject to tax and the modified retrospective basis should be used for the amendments related to changes in the ownership of foreign equity method investments or foreign subsidiaries and franchise taxes that are partially based on income.[219]

B. ASU Originated by the EITF

1. Improvements to Accounting for Costs of Films and License Agreements for Program Materials

In March 2019, in response to an EITF consensus, the FASB issued ASU No. 2019-02,[220] which addresses stakeholders' questions relating to the basis for different capitalization requirements related to production costs for films and for episodic television series in ASC Subtopic 926-20, Entertainment—Films—Other Assets—Film Costs ("ASC 926-20").[221] In addition, it addresses stakeholders' suggestions that the FASB align the guidance for license agreements for program materials in ASC Subtopic 920-350, Entertainment—Broadcasters—Intangibles—Goodwill and Other ("ASC 920-350"), to any changes made with respect to the capitalization requirements.[222] The FASB stated in ASU 2019-02 that it believes that the amendments, which apply to broadcasters and entities that produce and distribute films and episodic television series, will result in accounting that better reflects the economics of

215. *Id.*
216. *Id.*
217. *Id.*
218. *Id.*
219. *Id.* at 3.
220. Fin. Accounting Standards Bd., Accounting Standards Update No. 2019-02, Entertainment—Films—Other Assets—Film Costs (Subtopic 926-20) and Entertainment—Broadcasters—Intangibles—Goodwill and Other (Subtopic 920-350): Improvements to Accounting for Costs of Films and License Agreements for Program Materials, a Consensus of the FASB Emerging Issues Task Force (Mar. 2019) [hereinafter ASU 2019-02].
221. *Id.* at 1.
222. *Id.*

an episodic television series and provides more relevant financial information to users of financial statements.[223]

ASU 2019-02 amends ASC 926-20 to align the capitalization requirements for production costs of an episodic television series with the capitalization requirements for production costs of films by removing the content distinction for capitalization.[224] This action, which takes into account changes in production and distribution models in the entertainment industry, eliminates the limitation on capitalization of production costs for an episodic television series to the amount of revenue contracted for each episode in the initial market until persuasive evidence exists that revenue from secondary markets would occur or an entity could demonstrate a history of earning such revenue in that market.[225] An entity must reassess estimates of the use of a film for a film in a film group and account for any changes prospectively.[226]

The standard also requires an entity to test for impairment a film or license agreement for program material within the scope of ASC 920-350 at a film group level when the film or license agreement is predominantly monetized with other films or license agreements.[227] A "film group" is the lowest level having identifiable cash flows that are largely independent of the cash flows of other films or license agreements.[228]

ASU 2019-02 has the following additional provisions:

- It adds examples of events or changes in circumstances that indicate that an entity should assess for impairment a film group or an individual film after its release.[229]
- It requires an entity to reassess the predominant monetization strategy when a significant change in the monetization strategy occurs.[230]
- It aligns the impairment model in ASC 920-350 with the fair value model in ASC 826-20.[231]
- It requires an entity to write off unamortized film costs when a film is substantively abandoned.[232]
- It has provisions related to presentation, new disclosures about content that is either produced or licensed, and cash flow classification for license agreements.

223. *Id.*
224. *Id.*
225. *Id.*
226. *Id.*
227. *Id.*
228. *Id.* at 2.
229. *Id.*
230. *Id.*
231. *Id.*
232. *Id.*

The amendments in ASU 2019-12 are effective for financial statements of public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019.[233] For all other entities, the amendments are effective for financial statements for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years.[234] Early adoption is permitted, including in an interim period for which financial statements have not been issued.[235] The amendments may be applied prospectively at the beginning of the period that includes the adoption date.[236]

233. *Id.* at 2.
234. *Id.*
235. *Id.* at 2–3.
236. *Id.* at 3.

Caselaw Developments 2019*

Overview

Supreme Court. The Court held that an actor who does not violate subsection (b) of Rule 10b-5 because the actor did not "make" the misstatements can violate subsections (a) and (c) by disseminating the misstatements with knowledge that they are false.[1]

Further on the relationship between Rule 10b-5 subparts. Expanding on the Supreme Court's decision, the Tenth Circuit held that the majority owner of an investment adviser violated Rule 10b-5(a) and (c) by failing to correct statements in the adviser's Form ADV and on its website regarding a conflict of interest that could benefit that majority owner.[2]

Reliance. The Fourth Circuit affirmed dismissal of a Rule 10b-5 case brought by Chinese nationals where the plaintiffs alleged that they relied on statements from a variety of sources—including newsletters, social media, websites, and roadshows—but did not allege that they made any effort to translate the offering documents into Chinese or have English-speaking advisers review the documents.[3] The Seventh Circuit held that the non-reliance clause in a subscription agreement signed by employees of a financial firm precluded justifiable reliance by those employees on representations in "town hall" meetings held to discuss the conversion of debt that their employer owed them into equity interests in the employer.[4] The Second Circuit rejected a similar defense, where it rested on a simple merger clause saying that the LLC company agreement "constitute[d] the entire agreement" and "supersede[d] all prior agreements."[5]

Scienter and scienter pleading. The Fifth Circuit found scienter allegations insufficient, in one case as to statements about the performance of the issuer's product[6] and in a second case as to omissions about the effect of inventory levels on probable markdowns.[7]

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* The caselaw developments section covers opinions decided during the calendar year 2019. Where this portion of the annual review expresses opinions, they are those of the author of the caselaw developments survey, 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 31–63 and accompanying text.
2. *See infra* notes 64–78 and accompanying text.
3. *See infra* notes 85–99 and accompanying text.
4. *See infra* notes 100–11 and accompanying text.
5. *See infra* notes 112–30 and accompanying text.
6. *See infra* notes 138–54 and accompanying text.
7. *See infra* notes 155–70 and accompanying text.

Material misstatements. The Third Circuit found non-GAAP revenue not materially misleading in light of other disclosures the defendants made.[8] The Eighth Circuit, however, reversed dismissal of a claim alleging that a proxy statement for a merger misled by omitting one projected financial figure and mislabeling another, holding that the rest of the proxy statement did not so clearly remedy these deficiencies that the plaintiff's claim should be resolved at the pleading stage.[9] The Second and Eleventh Circuits found allegations of misstatements regarding regulatory compliance insufficient—in the first case regarding the healthcare insurance industry[10] and in the second case the financial industry.[11] The Second Circuit also found no materially misleading statements in an issuer's characterizations of its relationship with a business counterparty during repricing negotiations with that counterparty[12] and, in a different case, held that the government can prove the materiality of a misrepresentation by the testimony of a market participant, provided that the participant's view is not idiosyncratic but within the parameters of a reasonable investor in that market.[13]

Particularity of pleading omissions of illegal conduct. The Second Circuit held that a complaint alleging a Rule 10b-5 violation because an issuer stated that it competed with other companies, when in fact the issuer was engaged in an antitrust conspiracy, failed because the complaint did not include facts to show that the issuer's conduct satisfied all of the elements of an antitrust violation.[14]

Life sciences. The First and Ninth Circuits found no pled securities fraud in cases where plaintiffs alleged misstatements about adverse side effects and related commercial consequences.[15]

Insider trading. The Fifth Circuit usefully catalogued the elements of a tipper violation and connected evidence to each of them in a case featuring a tip about an acquisition.[16] In another case based on an acquisition, the First Circuit found evidence sufficient to support a duty of loyalty and confidence that a husband owed his wife and also to support the conclusion that the wife had not waived that duty, despite her having revealed some information about the acquisition to others in her husband's presence.[17] The Second Circuit upheld a tipping conviction against a challenge that the government had not proved that the tipper intended the tippee to trade, where the evidence showed the tipper conveyed information about an acquisition to his financial adviser, who bought securities in the target company that the defendant's law firm represented.[18]

8. *See infra* notes 179–200 and accompanying text.
9. *See infra* notes 201–23 and accompanying text.
10. *See infra* notes 224–38 and accompanying text.
11. *See infra* notes 239–54 and accompanying text.
12. *See infra* notes 255–69 and accompanying text.
13. *See infra* notes 270–90 and accompanying text.
14. *See infra* notes 291–302 and accompanying text.
15. *See infra* notes 303–35 and accompanying text.
16. *See infra* notes 339–65 and accompanying text.
17. *See infra* notes 366–91 and accompanying text.
18. *See infra* notes 392–402 and accompanying text.

Extraterritorial government enforcement of antifraud provisions. The Tenth Circuit interpreted section 22(c) of the Securities Act of 1933 ("Securities Act") and section 27(b) of the Exchange Act of 1934 ("Exchange Act")—giving district courts *jurisdiction* over extraterritorial violations of the antifraud sections in those acts where the case is brought by the government and either involves significant steps taken in the United States or a substantial effect in the United States—to mean that such extraterritorial violations fall within the *substantive definition* of those antifraud violations; and found that the government could pursue a defendant for such substantive violations where the defendant ran an internet-based Ponzi scheme through servers located in the United States and sold the securities to purchasers in other countries.[19]

Misstatements and omissions in proxy statements. In one proxy solicitation case, the Fourth Circuit held that a shareholder had no Rule 14a-9 claim based on the use of year-old financial figures to estimate the value of stock used as consideration in a merger where the proxy solicitation stated that it was using the dated numbers and that the estimated valuation had not been adjusted for more recent developments.[20] In a second case, that same court reversed dismissal of a Rule 14a-9 case, holding that a jury should decide the materiality of undisclosed discussions concerning the anticipated compensation at the surviving company of the target company's top executive, where plaintiffs alleged that that executive—in order to ensure the generous compensation discussed—failed to vigorously negotiate the price that the target shareholders would receive in the merger.[21]

Sanctions in SEC enforcement and criminal actions. The Second and Fifth Circuits declined to expand upon the Supreme Court's 2018 decision in *Kokesh v. SEC* to hold that district courts have no jurisdiction to order disgorgement in Securities and Exchange Commission ("SEC" or "Commission") cases, and the Supreme Court granted a writ of certiorari in another case to address that issue.[22] The Third Circuit held that an injunction in an SEC action is not, if granted on permitted criteria, a "penalty" within the meaning of that term in 28 U.S.C. § 2462's five-year statute of limitations.[23] The Second Circuit affirmed a sentence after the district court employed a two-level enhancement not included in the Sentencing Guidelines because those guidelines permit a trial judge to "depart from the Guideline range if there exists an aggravating . . . circumstance 'of a kind, or a degree, not adequately taken into account by the Sentencing Commission.'"[24]

Definition of a security. Three cases addressed whether financial instruments were "investment contracts" and so within the federal securities law definition of "security"—with the Fifth Circuit reversing summary judgment for the Commission on this issue in a case involving oil and gas joint ventures,[25] that same court

19. *See infra* notes 403–25 and accompanying text.
20. *See infra* notes 430–40 and accompanying text.
21. *See infra* notes 441–47 and accompanying text.
22. *See infra* notes 451–56 and accompanying text.
23. *See infra* notes 457–74 and accompanying text.
24. *See infra* notes 475–76 and accompanying text.
25. *See infra* notes 482–519 and accompanying text.

finding that the plaintiff alleged all elements of an investment contract for limited partnerships that were part of a complicated structure providing a specialized medical service,[26] and the Ninth Circuit affirming summary judgment for the SEC after it sued an attorney representing clients who bought interests in limited partnerships that made EB-5 investments, rejecting the argument that the clients were not investing with an expectation of profits but in order to gain permanent residency.[27]

Securities Litigation Uniform Standards Act ("SLUSA"). The Ninth Circuit found state law claims were not precluded by SLUSA where the challenged trades were allegedly self-interested ones made by a trustee and the claims were brought by a trust beneficiary who had no control over the trades.[28] The Seventh Circuit held that any class action making state law claims based on misrepresentations or omissions in the purchase or sale of a covered security—even if the class members number less than fifty-one—is a "covered class action" under one of SLUSA's two alternative definitions of that term.[29] The Third Circuit held that state law actions brought by sixteen opt-outs from federal securities class actions, and filed after those federal actions concluded by judgments on settlements, were not "covered class actions," and hence were not SLUSA-precluded, because they were never joined or consolidated with the federal class actions and never proceeded with those class actions for any purpose.[30]

Supreme Court

Relationship between Rule 10b-5 subparts. Rule 10b-5 prohibits, in connection with the purchase or sale of securities, (a) "employ[ing] any device, scheme, or artifice to defraud"; (b) "mak[ing] any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading"; or (c) "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[31] In 2011, the Supreme Court published its *Janus Capital Group, Inc. v. First Derivative Traders* decision in which it held that the "maker" of a statement within the meaning of subpart (b)—and hence the only person who could be liable as a primary violator of *that* subpart—was the person "with ultimate authority over the statement, including its content and whether and how to communicate it."[32] In doing so, the Court rejected the government's view that "makers" included all who "create" the statement.[33] Specifically, the Court saw "no reason to treat participating in the drafting of a false statement" as "making" the statement

26. *See infra* notes 520–50 and accompanying text.
27. *See infra* notes 551–76 and accompanying text.
28. *See infra* notes 582–91 and accompanying text.
29. *See infra* notes 592–602 and accompanying text.
30. *See infra* notes 603–16 and accompanying text.
31. 17 C.F.R. § 240.10b-5 (2020).
32. 564 U.S. 135, 142 (2011).
33. *Id.* at 144–45.

and, drawing on the analogy of a speechwriter and a speaker, concluded that "[e]ven when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it" so that the speaker makes the statements in the speech rather than the speechwriter.[34]

Applying the rule it announced, *Janus* reversed the Fourth Circuit, which had reversed a district court dismissal of a Rule 10b-5 claim against an investment adviser and its parent whom the plaintiffs contended "caused" mutual funds to issue prospectuses containing false statements.[35] The Court held that those defendants did not "make" the statements in the prospectuses, even though the plaintiff alleged that the investment adviser was "significantly involved in preparing the prospectuses."[36] Instead, the statements were made by the Massachusetts business trust into which the mutual funds were organized, which alone bore "the statutory obligation to file the prospectuses with the SEC" and was "a legally independent entity with its own board of trustees."[37]

While the Court in *Janus* thus analyzed Rule 10b-5's subpart (b) extensively, it did not address the relationship of that subpart to subparts (a) and (c). Last year, in *Lorenzo v. SEC*, the Court considered how the three subparts fit together.[38]

Lorenzo was the director of investment banking at a broker-dealer.[39] At the instruction of his boss, Lorenzo sent two October 14, 2009 emails to prospective purchasers of debentures being issued by an investment banking client.[40] The emails said that the debentures had "'3 layers of protection,' including $10 million in 'confirmed assets,'" even though Lorenzo knew at the time that the issuer "had '[w]rit[ten] off . . . all [of its] intangible assets,' and that its total assets (as of March 31, 2009) amounted to $370,552."[41] Lorenzo "signed the e-mails with his own name, he identified himself as 'Vice President—Investment Banking,' and he invited the recipients to 'call with any questions.'"[42] In an administrative enforcement proceeding, the SEC found that Lorenzo had violated Rule 10b-5, as well as Securities Act section 17(a).[43] On petition, the D.C. Circuit ruled that the evidence did not support the SEC finding that Lorenzo had violated Rule 10b-5(*b*), because his boss, not he, controlled the content and whether or not to send the emails.[44] But it found substantial record evidence to sustain the Commission's findings that Lorenzo had violated Rule 10b-5(*a*) and (*c*), as well as Securities Act section 17(a).[45]

34. *Id.* at 143, 145.
35. *Id.* at 140–41, 148; *id.* at 138 (identifying parties).
36. *Id.* at 147–48.
37. *Id.* at 147. The Court allowed that a statement embedded in one person's writing or speech that is specifically attributed to someone else is made by that other person. *Id.* at 142–43. But the prospectuses did not attribute any of the statements in them to the investment adviser. *Id.* at 147.
38. 139 S. Ct. 1094 (2019).
39. *Id.* at 1099.
40. *Id.*
41. *Id.* (some internal quotation marks omitted).
42. *Id.*
43. *Id. See also* Francis V. Lorenzo, Admin. Proceeding No. 3-15211, 2015 WL 1927763 (SEC Apr. 29, 2015).
44. Lorenzo v. SEC, 872 F.3d 578, 586–88 (D.C. Cir. 2017).
45. *Id.* at 588–95.

The Supreme Court granted certiorari to "consider whether those who do not 'make' statements (as *Janus* defined 'make' [for Rule 10b-5(b)]), but who disseminate false or misleading statements to potential investors with the intent to defraud, can be found to have violated the *other* parts of Rule 10b-5, subsections (a) and (c), as well as . . . [section] 17(a)(1)."[46] The Court answered that "they can."[47]

The Court assumed that Lorenzo was not the "maker" of the statements in the emails.[48] The majority, however, reasoned that this fact—while forestalling his liability under Rule 10b-5 subpart (b)—did not forestall his liability under subparts (a) and (c) because the argument in favor of that result rested on the faulty "premise . . . that each of these provisions should be read as governing different, mutually exclusive, spheres of conduct."[49] Instead, the Court held that the different subparts display "considerable overlap."[50] In this case, Lorenzo's conduct fell afoul of subparts (a) and (c) because, as found by the SEC, he "disseminat[ed] false or misleading information to prospective investors with the intent to defraud."[51] The Court "conclude[d that] dissemination of false or misleading statements with intent to defraud can fall within the scope of subsections (a) and (c) of Rule 10b-5, as well as [Exchange Act § 10(b) and Securities Act § 17(a)(1),] even if the disseminator did not 'make' the statements and consequently f[ell] outside subsection (b) of the Rule."[52]

The majority rejected two other arguments of note. First, Lorenzo cited a line of lower court decisions holding that, where the fraud consists solely of a misrepresentation, defendants can be pursued as primary violators only on Rule 10b-5 subpart (b) and not on subparts (a) and (c).[53] To the contrary, the Court held that subparts (a) and (c) could be employed against a defendant who did not "make" a statement even "when the only conduct involved concerns a misstatement."[54] Second, Lorenzo contended that permitting primary liability claims against non-makers in a case involving misrepresentations blurred the

46. *Lorenzo*, 139 S. Ct. at 1099.
47. *Id.*
48. *Id.* at 1100.
49. *Id.* at 1101–02.
50. *Id.* at 1102.
51. *Id.* at 1101.
52. *Id.* at 1100–01. The majority caveated, however, that liability under this theory "would typically be inappropriate" for "actors tangentially involved in dissemination—say, a mailroom clerk." *Id.* at 1101. But "the petitioner in this case sent false statements directly to investors, invited them to follow up with questions, and did so in his capacity as vice president of an investment banking company." *Id.*
53. Brief for Petitioner at 30–33, Lorenzo v. SEC, 139 S. Ct. 1094 (2019) (No. 17-1077), 2018 WL 4035341.
54. *Lorenzo*, 139 S. Ct. at 1100 (specifically disapproving WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc., 655 F.3d 1039, 1057–58 (9th Cir. 2011)). The majority also argued that its interpretation might be useful in cases "where a 'maker' of a false statement does *not* violate subsection (b) of the Rule (perhaps because he lacked the necessary intent)" but "a disseminator of those statements, even one knowingly engaged in an egregious fraud, could not be held to have violated the 'aiding and abetting' statute" because that statute requires "a primary violator to whom the secondary violator provided 'substantial assistance.'" *Id.* at 1104 (quoting 15 U.S.C. § 78t(e)).

line between primary and secondary liability and therefore fell afoul of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[55] The primary/secondary distinction is not so important in the SEC enforcement context, because the SEC can bring enforcement actions against aiders and abettors.[56] But it is critically important in private lawsuits, where *Central Bank* held that "a private plaintiff may not maintain an aiding and abetting suit under § 10(b)" and its implementing Rule 10b-5 and therefore private plaintiffs can *only* sue primary violators.[57] The *Lorenzo* majority, however, reasoned that "it is hardly unusual for the same conduct to be a primary violation with respect to one offense and aiding and abetting with respect to another," and therefore, in a case like the one before it, "[t]hose who disseminate[d] false statements with intent to defraud [we]re primarily liable under Rules 10b–5(a) and (c), § 10(b) . . . , even if they [we]re secondarily liable under Rule 10b–5(b)."[58]

Significance and analysis. Two justices dissented.[59] They concluded that the majority rendered *Janus*'s limitation of Rule 10b-5(b) a "dead letter."[60] The majority answered that it "assume[d] that *Janus*"—which held "that subsection (b) did not (under the circumstances) cover an investment adviser who helped *draft* misstatements issued by a different entity that controlled the statements' content"—"would remain relevant (and preclude liability) where an individual neither *makes* nor *disseminates* false information—provided, of course, that the individual is not involved in some other form of fraud."[61] The dissent responded that the proviso rendered the majority's purported preservation of *Janus* "illusory," "[g]iven that, under the majority's rule, administrative acts undertaken in connection with a fraudulent misstatement qualify as 'other form[s] of fraud.'"[62]

Lorenzo could have far-reaching effects. First, if "dissemination" is broadly defined, all kinds of actors who play some role in disseminating a representation that they did not "make" could risk primary Rule 10b-5 liability. For example, a broker might send a private offering memorandum to potential purchasers at the request of the issuer under conditions clearly showing that the issuer had ultimate control over both (i) the content of the memorandum and (ii) whether the broker would send it out. As another example, a client selling a security might instruct its attorney to repeat what the client said in response to a due diligence inquiry from a potential buyer, and the attorney might do so by telling the potential buyer that "in response to your inquiry, my client

55. *Id.* at 1103 (citing Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)).
56. 15 U.S.C. § 78t(e) (2018).
57. *Central Bank*, 511 U.S. at 191.
58. *Lorenzo*, 139 S. Ct. at 1103–04.
59. *Id.* at 1105–11 (Thomas, J., dissenting, joined by Gorsuch, J.). In some ways, *Lorenzo* is a reprise of *Janus*, but with Breyer (who dissented in *Janus*) authoring the majority decision, and Thomas (who authored the majority opinion in *Janus*) now dissenting.
60. *Id.* at 1110.
61. *Id.* at 1103 (majority opinion) (some emphasis added).
62. *Id.* at 1110 (Thomas, J., dissenting).

asked me to tell you." An expansive reading of *Lorenzo* might put such a broker or attorney at risk of a primary violation of subparts (a) and (c)—and thereby subject him or her to Rule 10b-5 liability in a private lawsuit—assuming that the offering memorandum or due diligence response contained material errors and the broker or attorney was at least reckless with regard to those errors.

Second, the majority's assumption that *Janus* will continue to "preclude" primary liability of those who draft misrepresentations but who do not disseminate them, while surely helpful in defining one of the continuing roles that subpart (b) will play, seems strange given that the majority specifically held that the various subsections should not be interpreted "as governing different, mutually exclusive, spheres of conduct."[63]

Courts of Appeals

Interpretation of Rule 10b-5(a) and (c). Following on *Lorenzo*, the Tenth Circuit affirmed an SEC order in *Malouf v. SEC*.[64] Mr. Malouf owned a Raymond James branch and was the majority owner of an investment adviser, UASNM.[65] In response to Raymond James's concerns that this created a conflict of interest, Mr. Malouf sold the Raymond James branch to Maurice Lamonde, with Lamonde paying for the purchase with 40 percent of the securities fees the branch generated over a four-year period with a cap slightly over $1 million on the aggregate payments.[66]

UASNM routed bond trades through the Raymond James branch after the sale, which generated fee income to the branch that Lamonde used to make the payments to Mr. Malouf to buy the branch.[67] UASNM's Forms ADV, filed with the SEC, did not disclose this conflict and UASNM's website "boasted that (1) UASNM's employees were not receiving any commissions or fees from the Raymond James branch and (2) UASNM was providing impartial advice untainted by any conflicts of interest."[68] Mr. Malouf "later acknowledged that his financial arrangement with Mr. Lamonde had created a conflict of interest that should have been disclosed."[69] He also conceded that "he regularly failed to seek competing bids for the trades [UASNM routed through the Raymond James branch and] . . . that he should have sought competing bids."[70] The SEC, which pursued Mr. Malouf in an administrative enforcement

63. *Id.* at 1102 (majority opinion), *cert. denied*, 2020 WL 1124532 (U.S. Mar. 9, 2020) (No. 19-909) (mem.).

64. 933 F.3d 1248, 1253, 1271 (10th Cir. 2019).

65. Dennis J. Malouf, Admin. Proceeding File No. 3-15918, SEC Release 4463, 2016 WL 4035575, at *2 & n.5 (SEC July 27, 2016) [hereinafter *SEC Malouf Decision*] (Malouf "owned" the Raymond James branch and was the 59.5 percent owner of UASNM).

66. *Malouf*, 933 F.3d at 1254 & n.1.

67. *Id.* at 1254.

68. *Id.*; *SEC Malouf Decision*, *supra* note 65, at *3.

69. *Malouf*, 933 F.3d at 1254.

70. *Id.*

proceeding for a variety of violations,[71] presented expert testimony that the commissions paid on the trades exceeded industry standards.[72]

The SEC concluded that Mr. Malouf himself violated Rule 10b-5(a) and (c), finding that he "had failed to correct UASNM's false or misleading statements, triggering liability for employment of a fraudulent or deceptive scheme."[73] Mr. Malouf argued on appeal "that liability cannot be based on his failure to correct UASNM's misstatements because the failure to correct is inseparable from the misstatements themselves."[74] Concluding that this argument rested on the notion that *Lorenzo* rejected—that a case in which the deceptive conduct consisted of false statements can only be pursued under Rule 10b-5(b) and cannot support a claim under Rule 10b-5(a) or (c)—the Tenth Circuit found Mr. Malouf's position untenable.[75] It held, instead, that the SEC reasonably found Mr. Malouf violated Rule 10b-5(a) and (c) because he "knew not only that a conflict existed but also that UASNM was telling its clients that he was independent. Despite this knowledge, [he] took no steps to correct UASNM's statements or to disclose his own conflict."[76]

Significance and analysis. *Lorenzo* endorsed imposition of Rule 10b-5(a) and (c) liability for *dissemination* of false statements. *Malouf* goes farther, extending such liability to failure to correct false statements. This suggests further erosion of the line between primary and secondary liability for false statements and the possibility that, indeed, (a) and (c) will render the protection provided by *Janus* "illusory," as the *Lorenzo* dissent warns.[77] Particularly disturbing is *Malouf's* failure to tie what the court seems to see as a duty to correct to the power of the alleged violator. Malouf was the majority owner of the UASNM and also its CEO.[78]

71. The SEC alleged that Mr. Malouf himself violated Rule 10b-5, Securities Act sections 17(a)(1) and 17(a)(3), and Investment Advisers Act ("IAA") sections 206(1) and 206(2). *Id.* at 1255. The Commission also alleged that he aided and abetted UASNM's violations of IAA sections 206(4) and 207, as well as SEC Rule 206(4)-1(a)(5). *Id.*

72. *Id.* at 1266–67.

73. *Id.* at 1255, 1259.

74. *Id.* at 1259.

75. *Id.* at 1259–60.

76. *Id.* at 1261. The court similarly declined to disturb the SEC finding that Mr. Malouf violated Securities Act sections 17(a)(1) and (3). *Id.*

The Tenth Circuit found the SEC reasonably determined that Mr. Malouf had scienter—a required element of a Rule 10b-5 violation and a Securities Act section 17(a)(1) violation—because he "was familiar with the contents of UASNM's Forms ADV and its website," "took no action to correct material misstatements on the forms or the website," lied to an outside consultant about it, and "dragged his feet even after being directed to disclose the conflict." *Id.* at 1262; *see also id.* at 1254–55 (UASNM had "hired an outside consultant to review [its] compliance procedures and Forms ADV," and while that consultant had "told Mr. Malouf and UASNM that the payments had created a conflict of interest that needed to be disclosed," UASNM did not disclose the conflict until "roughly nine months later").

On similar reasoning, the court held that IAI sections 206(1) and (2) prohibited conduct that included Mr. Malouf's failure to correct UASNM's statements and that the SEC had substantial evidence to conclude that Mr. Malouf's failure, under the circumstances set out above, demonstrated the required scienter. *Id.* at 1262–63. The same facts showed that the SEC reasonably found that he aided and abetted UASNM's violation of IAI sections 206 and 207 and SEC Rule 206(4)-1(a)(5). *Id.* at 1267–68.

77. *See* text at *supra* note 62.

78. *SEC Malouf Decision*, *supra* note 65, at *4.

Consequently, he had the power to correct the firm's ADV and website. Hopefully, Rule 10b-5(a) and (c) liability for failure to correct will be limited to those with the power to force correction. Otherwise, for example, an attorney reviewing an offering document might be liable under Rule 10b-5(a) and (c) for failing to suggest a correction, even if the attorney had no power to ensure that the correction was made.

Reliance. To prevail on a Rule 10b-5 claim, a private plaintiff must prove, among other elements, reliance on the misrepresentation or omission pled.[79] That reliance must be justified.[80] Justification can depend on offering documents that expressly limit the information on which purchasers say they are depending when they make their investments, or selling agreements setting out the representations by the offeror accompanied with a merger clause stating that the deal documents contain the entire agreement and supersede any prior agreements or representations.[81] The Fourth Circuit last year affirmed dismissal of a complaint where the plaintiffs sued on the basis of statements made in, on, or during newsletters, websites, social media, roadshows, and interviews, but did not read or ask advisers to review subscription documents before each invested $500,000 in a start-up company to produce hybrid and electric vehicles.[82] The Seventh Circuit affirmed dismissal in a case where the plaintiffs sued on the basis of oral misrepresentations but signed a subscription agreement in which they stated they had not relied on any information other than (i) that set out in two documents that failed to include the alleged misstatements and (ii) their own independent investigation.[83] In a case centered on a merger clause rather than a non-reliance provision, the Second Circuit vacated a defense summary judgment where investors sued on misstatements outside an LLC operating agreement.[84]

Reliance without reading offering materials, translating them into the investor's native language, or arranging for advisers to review the documents. In *Xia Bi v. McAuliffe*, the Fourth Circuit affirmed dismissal of both Rule 10b-5 and Virginia state law fraud claims brought by twenty-seven Chinese citizens, each of whom had invested $500,000 in a limited partnership that was then to loan the money to a corporation that produced hybrid and electric vehicles.[85]

79. Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 267 (2014).

80. 3 Thomas Lee Hazen, Treatise on the Law of Securities Regulation § 12.90 (2017) ("As is the case with fraud actions generally, in a securities fraud case, any reliance by the plaintiff must be reasonable.").

81. *Id.* § 12.80 ("The fact that an investor signed a statement denying reliance on other sources will not in and of itself preclude a Rule 10b-5 claim based on oral representations. . . . [But] a non-reliance clause will bear upon the reasonableness of the plaintiff's reliance on the alleged misrepresentations.").

82. *See infra* notes 85–99 and accompanying text.

83. *See infra* notes 100–11 and accompanying text.

84. *See infra* notes 112–30 and accompanying text.

85. 927 F.3d 177, 179, 182, 187 (4th Cir. 2019), *cert. denied*, 140 S. Ct. 654 (2019) (mem.). The investors sought thereby to participate in the immigration program known as EB-5, which provided a path to permanent residency in the United States if a foreign national invested $500,000 in rural or low-employment areas of the country and the investment created or preserved at least ten American jobs. *Id.* at 179.

The Private Placement Memorandum ("PPM") for the investment cautioned that the loan "was non-recourse [and] 'specifically exclude[d] customary provisions designed to protect the interests of lenders,'" with the PPM also disclosing that the borrowing corporation would make interest-only payments of 4 percent, 1.5 percent of which would be paid as a fee to the limited partnership's manager, a company that was affiliated with the borrowing corporation.[86]

The investors alleged a variety of false statements made during the offering: (i) that EB-5 money constituted only 7.8 percent of the corporate borrower's capital, whereas it comprised "far more"; (ii) that the limited partner's manager "chose" the corporate borrower as an investment opportunity, whereas the manager and the borrower were so linked that no real choice had been made; (iii) that the corporate borrower had sold 11,000 cars, whereas it had not; (iv) that the corporate borrower's first-year production would be sold to Denmark, whereas the company did not have any contract with Denmark; (v) that the company was the first to mass-produce low-speed electric cars, whereas it had not mass-produced any vehicles; and (vi) that the corporate borrower had 1,000 employees, whereas it had less than 100.[87]

After holding that the alleged misstatements traveled "beyond mere projections or puffery,"[88] the Fourth Circuit found decisive that both the state fraud claims and Rule 10b-5 required justifiable reliance on misstatements.[89] The complaint pled reliance in general terms: "Each of the Plaintiffs relied on some or all of the statements in . . . newsletters, statements on [the corporate borrower's] websites and social media, and statements made by [the individual defendants] . . . during roadshows, in interviews, and in written materials they authorized before" the plaintiffs invested.[90] The plaintiffs failed, however, to allege which of them relied on which misstatement or how each heard or read each one.[91] Moreover, "most of the alleged misstatements . . . were made in English," which many of the plaintiffs claimed "they [did] not understand"[92] and many of the falsehoods appeared in "American media, sometimes of the local variety."[93] The Fourth Circuit accordingly found it "far from clear how or whether plaintiffs learned of these statements."[94]

Beyond that, the PPM stated expressly that the corporate borrower "was 'a development stage company,' that was raising money to 'design, build, and

86. *Id.* at 180. The plaintiffs alleged that the limited partnership's manager and the corporate borrower "were under joint ownership and management." *Id.*

87. *Id.*

88. *Id.* at 183–84 (focusing particularly on the assertions that EB-5 money provided just 7.8 percent of the corporate borrower's capital and that the company had sold 11,000 cars and employed 1,000 workers).

89. *Id.* at 182–83.

90. *Id.* at 185 (quoting complaint).

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.*

commence production' of vehicles at a new production facility," contained the caution that the loans lacked standard lender protections, and warned in all capital letters that the investment was a high-risk speculation.[95] Thus, "the plaintiffs plainly 'possesse[d] information sufficient to call [the alleged] misrepresentation[s] into question.'"[96] Nevertheless, they signed their subscription documents "'without reviewing any version,'" and failed to allege "that they made any effort to translate the documents into their native language, or even asked any English-speaking attorney or investment advisor to review the documents for them."[97] The appellate court ruled it "unjustifiable" to invest "in a start-up company on the edge of new automotive technology" with "obviously . . . a high degree of risk . . . in reliance on stray media statements without so much as translating or even reviewing the subscription documents before signing them."[98]

Significance and analysis. The opinion provides a hodgepodge of explanations. Did the plaintiffs lose because they failed to plead which ones of them read or heard which alleged misrepresentations?[99] Did they lose because the PPM expressly contradicted at least some of the misstatements they pled? Did they lose simply because they failed to read the PPM or have advisers read the PPM, which also contained some fairly standard disclaimers? Without clarity, it is possible to argue that *Xia Bi* means an investor could lose a Rule 10b-5 case on a motion to dismiss if the investor pled that he or she heard a material lie spoken by a promoter but did not read a PPM that, while not contradicting the misrepresentation, included cautions that the issuer was a high-risk, speculative, high-technology start-up and that the transaction omitted some standard investor protections.

Defense based on a non-reliance clause. The Seventh Circuit published last year a more clearly articulated decision resting on an express non-reliance clause. Employees who converted loans to their LLC employer into equity interests brought a Rule 10b-5 claim against their employer and individual defendants, alleging that they relied on oral falsehoods at "'town hall' meetings" convened by the employer to discuss the conversion.[100] The employees asserted that, during those meetings, the individual defendants and other senior management at

95. *Id*. at 186 (citation to joint appendix omitted).

96. *Id*. (quoting Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1028 (4th Cir. 1997)).

97. *Id*.

98. *Id*. The panel rejected the argument that the defendants had diverted attention from these matters and inquiries that might have uncovered them, the Fourth Circuit reasoning that the claimants were provided with the relevant documents and nothing suggested that the defendants "prevented them from taking the modest step of reviewing the operative offering documents that they signed." *Id*. at 187. The court also said that defendants "had no generalized duty to translate the subscription documents for the benefit of foreign investors, especially when translation would open a new avenue of dispute and the English version of those documents would have been controlling in any event." *Id*.

99. The Fourth Circuit requires that those Rule 10b-5 elements not governed by the special pleading rules in 15 U.S.C. § 78u-4(b) must satisfy Rule 9(b) specificity requirements. *Id*. at 185. Rule 9(b) provides: "In alleging fraud . . . , a party must state with particularity the circumstances constituting fraud or mistake." Fed. R. Civ. P. 9(b).

100. Cornielsen v. Infinium Capital Mgmt., LLC, 916 F.3d 589, 593–96 (7th Cir. 2019).

their employer made the following misrepresentations, among others: (i) the LLC would have, after the conversion, a single class of equity interests, with all holders enjoying equal rights, when in fact the employees would receive non-voting interests void of any ability to influence management and the LLC was offering equity interests to cash investors that would be guaranteed against certain losses; (ii) the LLC had access to a $20 million line of credit it could use to address obligations it owed to two members of its advisory board, when in fact the LLC had, in the weeks before the conversion, "already drawn down $6 million" on that line, was insolvent, and "lacked the resources" to satisfy those obligations "or even to sustain [its] trading activities necessary to generate profits"; and (iii) employees who converted would "receive two free months of profit for January and February 2012, when in fact, [the LLC] had lost $4.3 million during that period and there was no profit for those months as a result."[101] All eligible employees elected to convert and did so by the end of March 2012.[102] By September 2013, their equity interests were worthless.[103]

Affirming the district court's dismissal,[104] the Seventh Circuit noted that the PPM provided to the employees expressly stated that their equity interests would have no voting rights and therefore no influence on management, and stated that the debt the LLC was taking on to satisfy its obligations to the two advisory board members came to $53 million and that this debt "could constrain or even eliminate [the LLC's] ability to obtain financing for its business pursuits."[105] The subscription agreement for the conversion included statements that (i) the LLC was a speculative venture, (ii) the investment was a high-risk one, and (iii) investors ran the risk of losing all their money.[106] It "also contained a non-reliance clause which stated: '[I]n entering into this transaction the undersigned is not relying upon any information other than that contained in the LLC Agreement, the Joinder and the results of the undersigned's own independent investigation.'"[107] The Seventh Circuit held that "the written representations in the Subscription Agreement preclude Plaintiffs from now claiming that they chose to participate in the Equity Conversion because they reasonably relied on the Individual Defendants' oral statements made during the town hall meetings."[108]

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101. *Id.* at 594–95.
102. *Id.* at 595. The appellate opinion does not provide the date of the conversion. The complaint alleges that all the conversions took place by March 30, 2012. Fifth Amended Complaint at para. 87, Cornielsen v. Infinium Capital Mgmt., LLC, Case No. 14-CV-00098, 2017 WL 4570308 (N.D. Ill. July 10, 2017), 2016 WL 8452136.
103. *Infinium Capital*, 916 F.3d at 596.
104. *Id.* at 593, 604.
105. *Id.* at 594 (quoting PPM).
106. *Id.* at 597.
107. *Id.* at 595 (quoting subscription agreement).
108. *Id.* at 597–98. The court of appeals concluded that dismissal "could be affirmed in large part on this basis alone," but went on to provide further justifications. *Id.* at 598. The court found that the complaint failed to properly plead a Rule 10b-5 claim because it failed to identify which defendants made which alleged misstatements, thereby running afoul of Rule 9(b)'s "required particularity." *Id.* at 599.

Significance and analysis. The investors in the Seventh Circuit case worked for a financial services company.[109] Moreover, they rested their claims on alleged oral misrepresentations, including ones that conflicted with the written PPM they received.[110] Accordingly, the decision fits within a line of cases questioning whether reliance on oral representations specifically contradicted by written offering materials is justified and resolving that issue by reference to multiple factors, including the sophistication of the investors.[111] The opinion, therefore, does not mean that simply including a non-reliance provision in a subscription agreement will automatically defeat a private federal securities claim under a rule or statute that includes reliance among its elements.

Defense based on a merger or integration clause. The defendants in *FIH, LLC v. Foundation Capital Partners LLC* also sought to defeat a section 10(b) claim on the basis of deal document language—in this case, however, not a non-reliance provision but a simple merger clause.[112] The plaintiff invested in a limited liability company that was a general partner of a limited partnership formed to invest in general partnerships of large hedge funds.[113] The plaintiff alleged it made its investment relying on false statements that (i) the LLC was "in active negotiations" for investments in two hedge funds, (ii) had a "[p]ipeline" of twenty-three additional possible investments, which had "'become increasingly active,'" and (iii) two of the managing principals of the LLC (who collectively owned over 92 percent of the LLC interests) "could 'work together' professionally," despite the fact that one of them was divorcing the other's sister-in-law.[114] In fact, the plaintiffs contended, internal LLC documents showed that (i) two of the prospective deals featured in due diligence materials provided to the plaintiffs before they invested were "'On Hold' with no ongoing negotiations," (ii) the number of potential deals the LLC was pursuing for the limited partnership was decreasing, and (iii) one of the two LLC principals had written to the other: "If you're going to continue to behave like this during the divorce, I really don't think it's wise for us to work together going forward" and "I know you despise me . . . . I'm really thinking of calling it quits . . . . We're all headed for disaster."[115]

The complaint also failed to adequately allege scienter, because it failed to separate out what facts were known by each individual, "making it impossible to assess the statements any Individual Defendant made at the town hall meetings against the information he allegedly possessed at the time he made them." *Id.* at 602.

109. Their employer was "a diversified alternative asset and risk management firm . . . [that] trade[d] exchange-traded and centrally cleared financial instruments offering fundamental arbitrage strategies." *Id.* at 593.

110. *See supra* notes 101 & 105.

111. *See, e.g.*, Bruschi v. Brown, 876 F.2d 1526, 1529 (11th Cir. 1989) (listing factors) (citing decisions from the First, Third, Fifth, Eighth, Ninth, and Tenth Circuits).

112. 920 F.3d 134, 136 (2d Cir. 2019).

113. *Id.* at 136–37.

114. *Id.* at 137.

115. *Id.* at 139 & n.4.

To make its investment, the plaintiff signed a subscription agreement that represented that the plaintiff had "such knowledge and experience in financial and business matters that [it] is capable of evaluating the merits and risks of an investment in the [LLC] Interest, and of making an informed investment decision, and [it] has consulted and relied solely upon the advice of its own counsel, accountant and other advisers with regard to such legal, investment, tax and other considerations regarding such investment and on that basis believes that an investment in an Interest is suitable and appropriate for [it]."[116] The plaintiff also represented that it had had an opportunity to ask questions and "obtain information necessary to verify the accuracy of the information provided."[117] The LLC in which the plaintiff invested made limited representations in the subscription agreement, with the court noting only two: (i) that the attached LLC company agreement was an accurate copy of that document and (ii) the LLC would not pay its LLC managers salaries exceeding amounts listed in an exhibit.[118] The attached LLC company agreement included a standard merger clause saying that that agreement "'constitutes the entire agreement of the Members and supersedes all prior agreements among the Members with respect to the subject matter hereof.'"[119] Notably, none of the agreements included "explicit language disclaiming reliance on external representations of the kind alleged by [the plaintiff] in this case (i.e., statements about ongoing deal activity or about personal relationships between Foundation's directors or officers)"[120]—even though the LLC had included such a clause in previous subscription agreements.[121]

On this record, the Second Circuit reversed the district court's grant of summary judgment for the defendants, which rested on the notion that "the merger clause contained in the Company Agreement made [the plaintiff's] reliance on defendants' misrepresentations unreasonable as a matter of law."[122] The appellate court held that "a general merger clause . . . is not sufficient as a matter of law to preclude reasonable reliance on material factual misrepresentations, even by a sophisticated investor."[123] Such a clause "operates to limit the universe of the parties' contractual obligations to the text of the contract itself," but does not "serve[] as a catch-all disclaimer of reliance on any conceivable pre-contract misrepresentations about facts pertaining to the subject matter of the contract that could form the basis of a claim for fraud in the inducement."[124]

116. *Id.* at 138 (quoting subscription agreement).
117. *Id.*
118. *Id.*
119. *Id.*
120. *Id.* at 142.
121. *Id.* at 138–39 ("[T]he Subscription Agreement omits specific anti-reliance disclaimers that Foundation had used in connection with other investments in the Fund."); *id.* at 139 n.3 ("For example, one such agreement stated that: 'Other than the Memorandum and the Partnership Agreement, the Subscriber is not relying upon any other information, representation or warranty by the Fund, the General Partner, or the Investment Manager in determining to invest in the Fund.'").
122. *Id.* at 136, 146; *id.* at 140 (quotation).
123. *Id.* at 141.
124. *Id.* at 143.

Significance and analysis. As its decision simply reversed summary judgment, the Second Circuit emphasized that, on remand, the defendants could "argue to a jury . . . that [the plaintiff] did not reasonably rely on any misrepresentations the jury might conclude were made."[125] And the court distinguished a previous case on the grounds that the stock purchase agreement there included not only a standard merger clause, but also twenty-nine representations/warranties and sixteen covenants.[126] Those extensive provisions "suggest[ed] a closed set of . . . representations upon which the plaintiff's reliance was acknowledged."[127] The Second Circuit distinguished a second previous decision on the grounds that the operative agreement contained a clause stating that "'[t]here are no restrictions, promises, warranties, or undertakings, other than those set forth or referred to herein'" and included "written representations" that "specifically addressed" the "subject matter of some of the alleged oral misrepresentations."[128]

All of this suggests that "careful investors negotiating the terms of an individualized investment can protect themselves by demanding that any representation that is critical to their investment decision be incorporated into the written investment agreement."[129] It also suggests that a seller should include an express non-reliance provision in deal documents and that the efficacy of both that provision and a standard merger clause in litigation alleging misrepresentations outside the deal documents increases if those documents include representations on a variety of matters so that the seller can convincingly argue that those representations were "a closed set."[130]

Scienter and scienter pleading. Through amendments introduced by the Private Securities Litigation Reform Act ("PSLRA"), the Exchange Act demands that a plaintiff seeking damages under that law must plead specific facts raising a "strong inference" of the "state of mind" that the asserted cause of action requires a defendant to have.[131] A Rule 10b-5 claim requires scienter.[132] Scienter consists of either "a mental state embracing intent to deceive, manipulate, or defraud"[133] or recklessness.[134] To adequately allege scienter, the pled facts must support "an inference of scienter" that is "more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent

125. *Id.* at 145.

126. *Id.* at 143–44 (citing and quoting Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc., 195 F. Supp. 2d 551, 562 (S.D.N.Y. 2002) (dismissing complaint), *aff'd*, 343 F.3d 189 (2d Cir. 2003)).

127. *Id.* at 144.

128. *Id.* (citing and quoting ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 95 (2d Cir. 2007) (affirming dismissal)).

129. *Id.* at 145.

130. In addition, of course, by placing the representations in the deal documents, the seller can be sure to include any materiality, knowledge, or other qualifiers—which, if made orally, can either be forgotten or hard to prove in the aftermath of a business meltdown.

131. 15 U.S.C. § 78u-4(b)(2)(A) (2018).

132. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

133. *Id.* at 193 n.12.

134. VIII Louis Loss et al., Securities Regulation 170 & n.555, 186 (5th ed. 2017).

intent."[135] In 2019, the Fifth Circuit affirmed dismissal in two cases, ruling that the plaintiffs failed to meet this demanding standard—the first involving a series of statements in which a CEO said proprietary software showed that oil and gas wells benefited from fracking technology that the issuer sold,[136] and the second resting on alleged omissions by the issuer that its elevated inventory could only be reduced by selling product at a significant markdown.[137]

Scienter respecting product performance. Investors who purchased Flotek Industries, Inc. ("Flotek") common stock between October 23, 2014, and November 9, 2015, sued the issuer and three officers, asserting a Rule 10b-5 claim based on alleged misrepresentations that data analyzed through Flotek's proprietary software ("FracMax") showed the efficacy and economic advantages of a fracking technology ("CnF") that Flotek sold to increase the productivity of oil and gas wells.[138] Affirming the district court's dismissal of the case,[139] the Fifth Circuit focused on scienter allegations regarding four statements.[140]

First, the CEO stated in a press release that "FracMax software technology provides conclusive evidence that our [CnF] suite of completion chemistries provides compelling economic benefits to production companies."[141] Because the plaintiffs did "not allege that CnF products provide no economic benefit whatsoever, but instead allege[d] the benefit was overstated," the executive's "generalized endorsement of FracMax as evidencing the 'compelling economic benefits' of CnF products [was] not unreasonable."[142] While the plaintiffs contended the CEO's characterization was reckless, given that Flotek had applied the software to data obtained from a third party without "internal controls" to check that data, the plaintiffs did "not allege that Defendants should have known the [third party] data was unreliable," making the use of the word "conclusive" "perhaps unwise," but "not reckless."[143]

Second, the CEO presented a slide show on at least one occasion that stated the data used in the FracMax analysis were "un-adjusted," which was not correct because the raw data came from a state agency that compiled the numbers lease by lease instead of well by well, and the software used an "allocation algorithm" to allocate reported numbers among multiple wells on a given lease.[144] But the complaint lacked a "specific allegation that [the CEO] knew at the time he made the statement at issue that FracMax utilized [the allocation] algorithm."[145]

135. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).
136. *See infra* notes 138–54 and accompanying text.
137. *See infra* notes 155–70 and accompanying text.
138. Alaska Elec. Pension Fund v. Flotek Indus., Inc., 915 F.3d 975, 979, 981 (5th Cir. 2019).
139. *Id.* at 979, 987.
140. *Id.* at 982.
141. *Id.* at 983.
142. *Id.*
143. *Id.*
144. *Id.*
145. *Id.* The Fifth Circuit added—without elaboration—that "the use of an algorithm does not make the claim that the data was 'un-adjusted' misleading." *Id.* (agreeing with the district court).

Third, at an investor conference, the CEO "presented images of the FracMax interface in order to compare the productivity of four Texas wells, one that used CnF and three that did not, . . . emphasizing the difference in production levels."[146] In fact, the data on the three non-CnF wells was incorrect because Flotek had erroneously applied the allocation algorithm to reduce those numbers, even though they were for single wells.[147] While it "appear[ed] that it would have been very easy to check if this data was correct" because Flotek admitted the error within one day of a financial blog post pointing out the mistake, "this suggests negligence," and "there is no indication that Defendants had reason to know of any deficiencies in quality control problems before the data was made public."[148]

Fourth and finally, the CEO said at the investor conference that the data he presented "was 'back-check[ed] and validate[d].'"[149] The CEO later admitted that Flotek had not cross-referenced data that it obtained from a third-party provider with data from the Texas Railroad Commission, the relevant state regulatory agency.[150] However, the complaint did not "allege that [the CEO] knew of this lack of quality control at the time he made the statement, or that it would have been so obvious that he should have known."[151] Moreover, the CEO's statement was "ambiguous because [the CEO did] not say whether Flotek itself back check[ed] and validate[d] the data, or instead relie[d] on a third party to do so, which [the CEO] may well have believed was a part of the process."[152]

Finishing with a "holistic" analysis, the Fifth Circuit examined the plaintiffs' overall theory: that the facts demonstrated scienter "based solely on the importance of FracMax to Flotek's business, Defendants' positions within the company, and the fact that the alleged 'mistake' happened in a way that made Flotek's core product, CnF, look more profitable."[153] To the appellate court, this amounted to no more than negligence.[154]

Significance and analysis. The CEO's repeated assurances at the investor conference make *Flotek* a difficult case. The court's analysis of the mistake about the three non-CnF wells seems reasonable. But the CEO added at the time that

146. *Id.* at 980.

147. *Id.*

148. *Id.* at 980, 984.

149. *Id.* at 985.

150. *Id.*

151. *Id.*

152. *Id.* The Fifth Circuit declined to apply the protocol that under "special circumstances" scienter can be inferred from a defendant's position within a corporate defendant. *Id.* at 985–86. The plaintiffs did not contend that Flotek was so small a company that its size justified this inference. *Id.* at 985. While "FracMax was important to Flotek's sales of CnF, it cannot be said to be critical to its 'continued vitality,' as required [by another special circumstance]." *Id.* at 986. The falsity of the statements was not "'readily apparent to the speaker.'" *Id.* (quoting Neiman v. Bulmahn, 854 F.3d 741, 749–50 (5th Cir. 2017), in turn quoting Local 731 I.B. of T. Excavators & Pavers Pension Tr. Fund v. Diodes, Inc., 810 F.3d 951, 959 (5th Cir. 2016)).

153. *Id.* at 986 (quoting district court).

154. *Id.* The Fifth Circuit added that the complaint suffered, overall, from group pleading of scienter instead of alleging "'the state of mind of the individual corporate official or officials.'" *Id.* (quoting Ind. Elec. Workers' Pension Tr. Fund IBEW v. Shaw Grp., Inc., 537 F.3d 527, 533 (5th Cir. 2008)).

the data in the presentation were "back-check[ed] and validat[ed]." The Tenth Circuit appears to let the CEO off the hook because, while the plaintiffs pointed to a specific check that would have revealed the error, they did not allege that the CEO knew that this specific check had not been made. The court then hints that the CEO *may* have believed that some other kind of check was in fact performed. This roundelay then ends with the plaintiffs unable to proceed even with discovery to determine whether the CEO in fact understood that *any* check or validation had been performed. Fair enough, the PSLRA was designed to prevent generalized complaints from imposing costly fishing expeditions through corporate files looking for a case that the plaintiffs do not have when they file suit. But it seems far from this goal to apply the special pleading rule to stop a case when the CEO states specifically that four data points have been validated and back-checked and—within a day of a critical blog post—the company can spot that three of the data points were clearly wrong. The case also suggests that executives can boast freely about "checks" on data they present, provided that they are sufficiently general so that they have not pinned themselves down in a manner that can be proved wrong. After all, almost any data has, in some sense, been backchecked and validated, even if compared, when typed, with a piece of paper containing handwritten numbers.

Scienter respecting effect of elevated inventory. Pier 1 Imports, Inc. ("Pier 1") announced "unplanned supply chain expenses" on February 10, 2015, "inventory related inefficiencies within the Company's distribution center network" on September 24, 2015, and, on December 16, 2015, an eighteen-month timeline to bring inventory down to align with demand.[155] Stock price declines followed each of these announcements.[156] Investors brought a Rule 10b-5 claim against the company, its CEO, and its former CFO, alleging that—from April 10, 2014, to December 17, 2015—the defendants "failed to tell investors about significant 'markdown risk'—the risk that Pier 1 had so much inventory that it could get rid of it only by lowering prices dramatically."[157]

Affirming dismissal, the Fifth Circuit concluded that the investors failed to adequately plead scienter.[158] The investors alleged that the two individual defendants had two motives to conceal the risk.[159] But the first—that they had "staked their careers" on the business strategy causing the inventory to balloon—failed because a simple "allegation of motive based on career prospects is insufficient."[160] And the second—that those defendants' cash bonuses depended on

155. Mun. Emps.' Ret. Sys. of Mich. v. Pier 1 Imps., Inc., 935 F.3d 424, 428 (5th Cir. 2019).

156. *Id.*

157. *Id.* at 428–29.

158. *Id.* at 427, 437.

159. *Id.* at 431. Although the opinion does not say this, the court surely concentrated on the scienter of the individual defendants because, in the Fifth Circuit, "[a] defendant corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter." Southland Sec. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 366 (5th Cir. 2004).

160. *Pier 1 Imps., Inc.*, 935 F.3d at 431.

the company's EBITDA—failed because "'incentive compensation "can hardly be the basis on which an allegation of fraud is predicated"'" since "'the vast majority of corporate executives' receive this type of compensation."[161] The court acknowledged an exception "when the potential bonus is extremely high and other allegations support an inference of scienter" (using an example from another case where the defendant "received a performance-based bonus that was 175 percent of his base salary"[162]), but found that exception inapplicable because—although the executives might have earned 288 percent and 200 percent of base salary respectively at the top end of the incentives, the company's EBITDA in fact fell below the threshold number needed for even the lowest incentive payments (respectively 11.5 percent and 8 percent of base salary).[163] Accordingly, the court "reject[ed] the investors' motive allegations as creating *any* inference of scienter, much less a strong one."[164]

While the investors also alleged facts to show that the individual defendants knew "that Pier 1's inventory was high," "[k]nowledge of high inventory does not necessarily equate to knowledge of significant markdown risk—an equally plausible inference is that [the CEO] and [former CFO] reasonably believed they could fix the excessive inventory problem without resorting to markdowns."[165] Turning to the allegations more specific to markdown risk, the investors asked the court to infer the executives' knowledge of that danger from their knowledge of excessive inventory levels because the inventory consisted of "trend-based" merchandise that could not be sold for full price once the trend passed.[166] But the company protested that "it never describes itself as a 'trend-based fashion retailer' subject to markdown risk" and that "while some of the products are designed to be predictive of trends in home décor, a large percentage of its inventory is . . . comprised of 'long-standing collections' of 'products that do well for [Pier 1] day in and day out'"—with about "50 percent of its inventory during the Class Period . . . 'rebuy' goods, such as the company's well-known papasan chair."[167] Finally, the court rejected the argument that Pier 1 had a duty under Item 303 of Regulation S-K to report the markdown risk as a "'trend[] or uncertaint[y] . . . that the [company] reasonably expect[ed to] have a material . . . unfavorable impact on . . . revenues.'"[168] The Fifth Circuit found this position to "assume[] its conclusion: that [the CEO] and [the CFO]

161. *Id.* (quoting Ind. Elec. Workers' Pension Tr. Fund IBEW v. Shaw Grp., Inc., 537 F.3d 527, 544 (5th Cir. 2008) (quoting Tuchman v. DSC Commc'ns Corp., 14 F.3d 1061, 1068 (5th Cir. 1994))).

162. *Id.* (referring to Barrie v. Intervoice-Brite, Inc., 397 F.3d 249, 261 (5th Cir. 2005)).

163. *Id.*

164. *Id.*

165. *Id.* at 431–32.

166. *Id.* at 434–36. The plaintiffs pled that the CEO had characterized Pier 1's products as "'reflect[ing] current fashion trends.'" *Id.* at 435. The company also said, in an SEC filing: "'The success of the Company's specialty retail business depends largely upon its ability to predict trends in home furnishings consistently and to provide merchandise that satisfies customer demand in a timely manner.'" *Id.*

167. *Id.* at 435 (quoting both district court and defendants).

168. *Id.* at 436 (quoting 17 C.F.R. § 229.303(a)(3)(ii)).

'reasonably expect[ed]' that the high inventory ran the risk of significant markdowns."[169]

Significance and analysis. The court's treatment of incentive compensation provokes two thoughts. First, the notion that even a 175 percent of base salary bonus might contribute to scienter puts a significant percentage of executives at risk of a scienter inference simply due to the structure of their compensation.[170] Second, comparing the actual payout to the salary instead of the possible payout poses timing problems. An actual low or no payment for failure to reach some threshold is meaningful to a scienter analysis if, at the time he or she made a particular statement, the speaker knew that the odds of getting a much higher payout were so small that a fraudulent statement or omission would not bring the big money within reach. But if, at the time of speaking, the executive believed that a large incentive payment might be achieved through fraud, that possibility creates an incentive for misrepresenting even if, after the performance period ends, the company's financial figures prove so meager that the executive receives only a small payment, or none at all. To properly incorporate an incentive structure into a scienter analysis, the plaintiff should bear the burden of pleading specific facts to show that any given incentive structure provided a motive to lie, taking into account the probability spread of incentive payments and the likely effect of misrepresentations on that spread—all evaluated at the time the defendant spoke or wrote.

Material misstatements. A fact 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.'"[171] Context matters. Even a statement that misleads may prove immaterial if "the true statements . . . discredit the [misleading] one so obviously that the risk of real deception drops to nil" and thereby "render[s] a misleading proposition too unimportant to ground liability."[172] In 2019, the Third Circuit applied this principle to reject a claim that non-GAAP revenue figures misled,[173] and the Eighth Circuit invoked this protocol but reversed dismissal—in a case centering on omission of projected net income and mislabeled internal financial projections in a merger proxy statement—holding that the other disclosures to which defendants pointed were insufficient to render the omission and misstatement immaterial as a matter of law.[174]

169. *Id*. The court added that the Fifth Circuit had "never held that Item 303 creates a duty to disclose under the Securities Exchange Act." *Id*. It did not reach that issue here because, even assuming that Item 303 applied, the investors could not use it to support scienter absent showing that the executives believed that the company was running the markdown risk.

170. *See* Equilar, Inc., CEO Pay Trends 8, 12 fig. 3a (2019) (reporting, after examining compensation at 500 companies, a median CEO salary of $1,200,000 and a median bonus of $2,388,000—199% of the salary).

171. Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).

172. Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991).

173. *See infra* notes 179–200 and accompanying text.

174. *See infra* notes 201–23 and accompanying text.

In other opinions, the Second Circuit found wanting allegations that a health-care insurer materially misstated its regulatory compliance,[175] and the Eleventh Circuit found insufficient allegations regarding similar statements of compliance in the financial industry.[176] The Second Circuit also held that representations about relations with an important customer while the issuer renegotiated pricing with that customer were not materially misleading[177] and, in a different case, that the materiality of a misrepresentation can be proved by the testimony of a participant in the relevant security market, provided that the testimony is not idiosyncratic.[178]

Arguably misleading non-GAAP revenue numbers cured by disclosures. The *Fan v. StoneMor Partners LP* plaintiffs purchased units issued by a limited partnership participating in the funeral industry.[179] State law required StoneMor to hold in trust payments by customers to whom the company made "pre-need" sales—of services and products the customers would not need until they died.[180] Generally accepted accounting principles ("GAAP") prohibited StoneMor from reporting receipts from pre-need sales as current revenue.[181] StoneMor, however, provided investors with non-GAAP numbers "that represented pre-need sales as a portion of present-day current revenue."[182] StoneMor also borrowed money in amounts of those pre-need receipts held in trust, made distributions to limited partners from that money, then repaid the borrowing by selling additional equity interests.[183]

In September 2016, StoneMor disclosed that it would restate financial numbers covering about three years of operations.[184] As a result, StoneMor could not sell additional equity and substantially reduced its distributions.[185] Purchasers of limited partnership units before this disclosure filed a Rule 10b-5 lawsuit, contending that three types of StoneMor statements before the restatement announcement were false or misleading.[186]

Affirming dismissal, the Third Circuit held, with respect to each category, that "StoneMor disclosed sufficient information to render them immaterial."[187] First, StoneMor said that it "determine[d] the distribution based on the operating performance of the company and the resultant Available Cash at the end of the quarter."[188] The plaintiffs alleged that this was untrue because the partnership "'could not, and never intended to fund the distributions from the performance

175. *See infra* notes 224–38 and accompanying text.
176. *See infra* notes 239–54 and accompanying text.
177. *See infra* notes 255–69 and accompanying text.
178. *See infra* notes 270–90 and accompanying text.
179. 927 F.3d 710, 713 (3d Cir. 2019).
180. *Id.*
181. *Id.*
182. *Id.*
183. *Id.* at 713–14.
184. *Id.* at 714.
185. *Id.*
186. *Id.* at 714–15.
187. *Id.* at 716.
188. *Id.* at 715 (quoting exemplar press release).

of the business, i.e., from day-to-day business operations'" and, instead, "its 'ability to fund cash distributions was contingent on its access to the capital markets.'"[189] But the partnership 10-Ks defined the term "Available Cash" to include "'working capital borrowings,'" and those filings stated expressly that the partnership "'may not have sufficient cash from operations to continue paying distributions at their current level, or at all.'"[190] The Third Circuit held that this "disclosure, among others, would alert reasonable investors to the real business risks facing StoneMor."[191]

The second category of statements, which seems much like the first, "concern[ed] the fact that StoneMor's distributions were funded in large part through its cash borrowings, and not its day-to-day operating revenue."[192] As to these, every StoneMor annual report during the period of the alleged fraud included "GAAP and non-GAAP financials side-by-side, which demonstrated the mathematical reality that StoneMor was not able to fund its distributions primarily from its day-to-day operations because much of that cash was being held in state trusts and was unrecognized by GAAP."[193] Moreover, in a presentation to investors, the partnership showed "its distribution amount and non-GAAP operating profits towering over its GAAP operating profit."[194] The Third Circuit concluded that these disclosures "render[ed] any . . . perceived misstatement" about the source of money the partnership distributed "immaterial."[195]

Third, the plaintiffs contended that StoneMor misled by statements that failed to disclose that the partnership used equity proceeds to pay down the debt it incurred to raise money to pay out in distributions.[196] As to these, the court quoted from a partnership press release stating that it "'intend[ed] to use the net proceeds from [an equity] offering to pay down outstanding indebtedness under its revolving credit facility'" and a quarterly report stating that proceeds from an offering were used for that purpose.[197] The panel concluded that "[i]n light of these disclosures," "a reasonable investor would have been aware of the fact that StoneMor used equity proceeds to pay down its debt."[198]

Significance and analysis. Importantly, in setting out the principle that the Third Circuit applied, the Supreme Court stated: "not every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain

189. *Id.* (quoting complaint).
190. *Id.* at 716 (quoting filings).
191. *Id.*
192. *Id.* at 717.
193. *Id.*
194. *Id.*
195. *Id.*
196. *Id.*
197. *Id.* (some alteration to original).
198. *Id.* The court also held that the complaint failed to allege facts supporting a strong inference of scienter. *Id.* at 717–18. It rested this holding on the disclosures set out in the text, saying that they "do not demonstrate an intent to defraud—rather, they accurately show how StoneMor leveraged its assets in order to maximize its distributions despite the state trust requirements attached to its preneed sales." *Id.* at 718.

materially so, and liability should follow."[199] Accordingly, the defense that truthful disclosures render a misleading statement immaterial should prevail only in the instance in which a reader of the curative disclosures need make almost no inference (and certainly no sophisticated inference) in order to clear up his or her misunderstanding. The *StoneMor* plaintiffs' case could be characterized as one in which the partnership deceived by failing to connect all three legs of what the court called a "feedback loop . . . : cash distributions were funded by borrowed cash, that borrowed cash was paid down through equity proceeds, and equity proceeds were continuously attracted through growing pre-need sales and cash distributions."[200] By this theory, disclosures that separately connected two of the three legs—(i) that distributions were funded by debt rather than by GAAP revenues and (ii) that equity offering proceeds paid down debt—arguably would not suffice to cure deception founded on the interrelationship between all three, as that connection arguably would require the kind of inference that the Supreme Court did not countenance.

Disclosures did not render omission of projected standalone income figure and mislabeled standalone internal financial projection in merger proxy statement immaterial as a matter of law. In *Campbell v. Transgenomic, Inc.*, the Eighth Circuit also faced the argument that allegedly misleading statements were immaterial as a matter of law in light of disclosures that the defendants had made.[201] In this case, the argument failed to convince the court of appeals, which accordingly reversed dismissal.[202]

The plaintiff owned shares in Transgenomic, Inc., which merged with Precipio, Inc. ("Old Precipio"), with the surviving company also named Precipio, Inc. ("New Precipio").[203] Transgenomic solicited its shareholders, including the plaintiff, to vote in favor of a merger through a proxy statement.[204] The plaintiff brought a claim under section 14(a) of the Exchange Act and SEC Rule 14a-9, claiming that the proxy statement included false and misleading statements and omissions.[205]

The case focused on two matters. First, the plaintiff contended "that the proxy statement was materially misleading because it omitted [Old] Precipio's projected net income/loss (which the Transgenomic board reviewed before approving of the merger)."[206] And, the "proxy statement also omitted expenses that would allow investors to independently calculate [Old] Precipio's net income/loss from its revenue projections and gross profit."[207] While Transgenomic countered that the statement "fully disclosed other important metrics such as projected unlevered free cash flows, revenue projections, and gross profit,"[208]

199. Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991).
200. *StoneMor Partners LP*, 927 F.3d at 714.
201. 916 F.3d 1121 (8th Cir. 2019).
202. *Id.* at 1123, 1128.
203. *Id.* at 1123.
204. *Id.* at 1123–24.
205. *Id.*; *see* 15 U.S.C. § 78n(a) (2018); 17 C.F.R. § 240.14a-9 (2020).
206. *Transgenomic, Inc.*, 916 F.3d at 1124.
207. *Id.*
208. *Id.*

the Eighth Circuit nevertheless found that Old "Precipio's projected net income/loss is not trivial information."[209] Moreover, while the proxy statement included Old Precipio's gross profit projections, this was arguably "materially misleading" given that Old Precipio's projected net income/loss was "significantly lower."[210] The Eighth Circuit then held that the materiality of the omitted net income figure "was improperly resolved as a matter of law" when the district court granted the defense motion to dismiss.[211]

Second, the proxy statement contained a table labeled "Revenue Distribution," including numbers identified as "Precipio's internal financial projections."[212] Transgenomic conceded that the proxy statement identified "Precipio" as Old Precipio, while the numbers in the table were, in fact, the projected numbers for New Precipio.[213] Transgenomic argued, however, that a reasonable investor would have known that the numbers were those of New Precipio for three reasons: (i) the numbers included a line for "Technology" and, since Transgenomic was a technology company, a reader would have deduced that the figures constituted projections for the New Precipio (which, of course, would include the pre-merger Transgenomic and all that company's technology); (ii) the numbers in the mislabeled portion of the table corresponded with numbers seven and ten pages earlier that were correctly identified as numbers for New Precipio; and (iii) one of the places in the mislabeled part of the table was blank, signaling that the numbers were for the post-merger company, which was New Precipio.[214] The court responded: (i) Old Precipio was also "in part" a technology company; (ii) the proxy statement, in places, used "Precipio" to mean Old Precipio, including passages that referred to financial numbers, so therefore reference to previous "Precipio" numbers might not have helped the reader understand the error in the table; and (iii) if blank spaces in the table for the year prior to the merger had signaled that the other numbers in the table were for the post-merger company, then all the numbers for the year prior to the merger should have been blank, but they were not.[215] Overall, the question of "[w]hether a reasonable investor would decipher from other clues in the proxy statement that 'Precipio' in the 'Revenue distribution' table refers to '[Old] Precipio' [was] a question . . . that the district court should not have decided as a matter of law on a motion to dismiss.[216] Instead, as on the first issue, the matter should be left to trial.[217]

Significance and analysis. *Transgenomic, Inc.* comes out right on the incorrectly labeled table. The argument that disclosures can render allegedly misleading

209. *Id.* at 1125, 1123 (noting that the circuit had, in an earlier case, "considered net income to be among the three most valuable figures in determining the fairness of an acquisition under the Clayton Act. *See Mississippi River Corp. v. FTC*, 454 F.2d 1083, 1086 (8th Cir. 1972).").

210. *Id.* at 1125.

211. *Id.* at 1123, 1125–26.

212. *Id.* at 1126.

213. *Id.*

214. *Id.* at 1126–27.

215. *Id.* at 1127.

216. *Id.*

217. *Id.*

omissions, or outright errors, immaterial—particularly as a matter of law—should prevail infrequently and only when the disclosures reveal the truth so clearly that no reasonable investor could mistake it.[218] The test is not whether a reader is so attentive or trained that he or she can remember figures on one page when reading figures several pages later and—looking for inconsistencies between the two—can notice errors and correct them.[219] So "clues" won't do.[220]

On the other hand, the Eighth Circuit provided questionable reasoning to support its conclusion that omission of the projected net income figure was possibly misleading because the disclosed projected gross profit was significantly larger than the undisclosed net income.[221] Gross profit consists of revenue minus the cost of goods sold.[222] Net income subtracts from that figure general and administrative costs, interest costs, and depreciation.[223] Necessarily, then, the second figure will be less than the first. It is fair to hold that a reasonable investor knows this and that, therefore, disclosure of the gross figure is not even arguably misleading simply because it fails to state the arithmetically certain fact that it is greater than the net figure.

Representations of regulatory compliance in the healthcare insurance industry. In a more mundane materiality decision, the Second Circuit affirmed dismissal of a Rule 10b-5 action resting on alleged misrepresentations about the issuer's regulatory compliance.[224] The investors purchased the stock of Cigna Corporation ("Cigna") after Cigna acquired HealthSpring Inc. and thereby entered the Medicare insurance market.[225] During the period of the alleged fraud, Cigna stated in February 2014 and February 2015 that it had "'established policies and procedures to comply with applicable [regulatory] requirements'" and that it "'expect[ed] to continue to allocate significant resources' to compliance."[226] In December 2014, Cigna published a "Code of Ethics and Principles of Conduct" that "stated that 'it's so important for every employee . . . to handle, maintain, and report on [Cigna's financial] information in compliance with all

218. That is the message from the Supreme Court. *See supra* notes 172, 199, and accompanying text.

219. *Transgenomic, Inc.*, 916 F.3d at 1127 ("The point of a proxy statement, after all, should be to inform, not to challenge the reader's critical wits." (quoting *Va. Bankshares*, 501 U.S. at 1097)).

220. *Id.* at 1126 ("Transgenomic counters that the label is not materially misleading because other clues in the proxy statement tell shareholders that the figures in this table refer to post-merger Precipio."); *id.* at 1127 ("[A]s a matter of law, the clues cited by Transgenomic do not mean that the 'Revenue distribution' table is not materially misleading.").

221. *See* text accompanying *supra* note 210.

222. *How Do Gross Profit and Net Income Differ*?, Investopedia, https://www.investopedia.com/ask/answers/101314/what-are-differences-between-gross-profit-and-net-income.asp (last visited May 7, 2020) ("Gross profit = Revenue - Cost of Goods Sold").

223. *Id.* ("Net income is the profit after all expenses have been deducted from revenues. Expenses can include interest on loans, general and administrative costs, income taxes, interest, depreciation . . . .").

224. Singh v. Cigna Corp., 918 F.3d 57, 60, 62, 65 (2d Cir. 2019).

225. *Id.* at 60.

226. *Id.* at 60–61.

laws and regulations,' and that 'we have a responsibility to act with integrity in all we do, including any and all dealings with government officials.'"[227] The company also stated that its "Medicare business was 'subject to . . . numerous and complex regulations and requirements that are frequently modified and subject to administrative discretion'" and expansively discussed "the difficulty of compliance given the regulatory uncertainty surrounding legislation and implementation of national healthcare reform."[228]

The regulatory body overseeing Medicare issued over seventy-five notices to Cigna from April 2014 through December 2015 for "a variety of compliance infractions."[229] In October 2015, that regulator advised Cigna that (i) the company had "substantially failed to comply with [Medicare] requirements"; (ii) the company "has had a longstanding history of non-compliance with [those] requirements"; and (iii) the regulator was suspending Cigna's right to accept new enrollment of new Medicare beneficiaries.[230] Cigna's stock price declined in four days from $140.13 to $135.85.[231]

The Second Circuit was unimpressed. Starting with the bedrock definition that "[a]n alleged misrepresentation is material if 'there is a substantial likelihood that a reasonable person would consider it important in deciding whether to buy or sell shares of stock,'"[232] it found the statements in Cigna's Code of Ethics "a textbook example of 'puffery[,]' . . . 'too general to cause a reasonable investor to rely upon them.'"[233] And the company's statements about "having 'policies and procedures' and allocating 'significant resources'" constituted only "simple and generic assertions."[234] Moreover, the company's "acknowledgements of the complexity and numerosity of applicable regulations" and the repeated admissions that it would need to devote "'*significant* resources'" to compliance, suggested the "uncertainty as to the very possibility of maintaining adequate compliance mechanism in light of complex and shifting government regulations."[235] Putting it all together, the court found the challenged representations "tentative and generic" and, in light of the company's emphasis on its "complex [and] evolving regulatory environment," assertions that did not "'significantly alter[] the total mix of information'" and were therefore not material.[236]

227. *Id.* at 61.
228. *Id.* at 60–61.
229. *Id.* at 61.
230. *Id.*
231. *Id.* at 61–62.
232. *Id.* at 63 (quoting Operating Local 649 Annuity Tr. Fund v. Smith Barney Fund Mgmt. LLC, 595 F.3d 86, 92–93 (2d Cir. 2010) (internal quotation marks and brackets omitted)).
233. *Id.* (quoting City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG, 752 F.3d 173, 183 (2d Cir. 2014) (internal quotation marks omitted)).
234. *Id.* at 64.
235. *Id.*
236. *Id.* (quoting ECA, Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 197 (2d Cir. 2009) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988)) (internal quotation mark omitted)).

Significance and analysis. The Second Circuit contrasted the language that Cigna used with the words of an issuer in a 2014 decision.[237] There the defendant identified specific pollution abatement equipment it had installed, touted environmental teams conducting twenty-four-hour monitoring at its operational sites, and asserted that the Chinese government had imposed no environmental penalties on the issuer.[238] Unmistakably, the court of appeals suggests that a company protects itself against a securities lawsuit best by describing its regulatory compliance with pleasant platitudes, coupled with cautions of intricate and challenging rules, rather than a robust description providing details that would permit investors to evaluate regulatory risk. This is an odd incentive in today's regulation-rich business climate.

Representations of regulatory compliance in the financial industry. The Eleventh Circuit, too, affirmed last year dismissal of a Rule 10b-5 lawsuit resting on hopeful but general statements, opinions, and projections of regulatory compliance.[239] The issuer serviced mortgages "by processing borrower payments, administering loan loss-mitigation operations, and managing foreclosures."[240] During 2009 to 2012, it experienced explosive growth, with the loans it serviced increasing from 350,000 to 1,200,000 and their aggregate unpaid balance increasing from about $50 billion to more than $200 billion.[241] The issuer tried to keep up with this expansion by using software named REALServicing.[242]

Regulatory agencies instituted and settled a raft of proceedings against the company, beginning in 2012 and continuing into 2017.[243] Investors who bought the issuer's stock between January 13, 2015, and April 20, 2017, sued the issuer and executives for statements about regulatory compliance made during that period.[244]

The Eleventh Circuit organized these representations into several, sometimes overlapping, groups and found none of them sufficient to support a claim.[245] Some were "immaterial 'puffery'"—such as "proclamations that [the company]

237. *Id.* (citing to and quoting from Meyer v. Jinkosolar Holdings Co., 761 F.3d 245, 251 (2d Cir. 2014)).

238. *Id.*

239. Carvelli v. Ocwen Fin. Corp., 934 F.3d 1307, 1313, 1316, 1332 (11th Cir. 2019).

240. *Id.* at 1313.

241. *Id.*

242. *Id.*

243. The CFPB filed a civil action against Ocwen in 2012. *Id.* at 1314. The company entered into a consent order with forty-nine state attorneys general in 2013, one with the New York Department of Financial Services in 2014, and one with the California Department of Business Oversight in 2015. *Id.* A spinoff disclosed in February 2017 that the CFPB was considering an action against it for violations related to REALServicing, and in April of that year, a cease-and-desist order forbade the issuer from acquiring service rights for any additional mortgages until the company addressed problems relating to mortgage-escrow accounts. *Id.* at 1315–16.

244. Carvelli v. Ocwen Fin. Corp., Case No.: 9:17-cv-80500-RLR, 2018 WL 4941110, at *1 (S.D. Fla. Apr. 30, 2018).

245. *Carvelli*, 934 F.3d at 1318 ("After careful review, we find that none of Ocwen's statements rises to the level of an actionable misrepresentation of material fact. Some statements are immaterial puffery, some are mere statements of opinion, some fall within the PSLRA's safe-harbor for forward-looking statements, and still others are simply not alleged to be false.").

was devoting 'substantial resources' to its problems, with 'improved results,' as well as its boasts that it was taking a 'leading role' and making 'progress' toward compliance."[246] "[B]ecause . . . a reasonable investor wouldn't have regarded such corporate banalities as relevant in deciding whether to invest in [the company] in the first place," these statements did not mislead by failing to disclose the company's problems with its REALServicing software.[247]

Other statements were opinions—such as the company "believ[ing] that our competitive strengths flow from our ability to control and drive down delinquencies through the use of proprietary technology" and "believ[ing] significant investments in our servicing operations, risk and compliance infrastructure over recent years will position us favorably relative to our peers" and "expect[ing] the next round of results from the National Mortgage Settlement monitor to show that we have made progress in improving our internal testing and compliance monitoring."[248] The Eleventh Circuit concluded, as to these, that the complaint did not allege them to be false because the plaintiff failed to allege either that the issuer did not genuinely believe these statements or that the statements included "embedded false statements of fact."[249] The court added that "none of [the company's] statements of opinion are mutually exclusive of—or even inconsistent with—[the company's] alleged knowledge that it had persistent software problems. [The company] could have believed both that REALServicing was a mess—even a 'train wreck'—*and* that it had made progress towards compliance."[250]

Finally, the Eleventh Circuit held that some of the challenged statements were forward-looking ones protected by 15 U.S.C. § 78u-5(c)(1)—such as (i) the issuer's expectations that (a) "our ongoing cooperation [with the California Department of Business Oversight would] result in a satisfactory outcome for all parties"; (b) the company would "continue to be profitable and generate strong operating cash flow"; (c) it would "continue to demonstrate strong corporate governance, risk management and compliance management"; and (d) it would "continue to refocus on improving operating margins in the servicing business"; and (ii) its belief that (a) its loan servicing score "should improve to levels similar to other large servicers" and (b) the company would "continue to provide strong servicing results."[251] The Exchange Act provides that no private plaintiff can recover on a forward-looking statement that is identified as such and "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[252] Cautionary words meet this standard if they "warn an investor 'of risks of a significance similar to that actually realized' and provide adequate 'notice of the danger of

246. *Id.* at 1318, 1321.
247. *Id.* at 1322.
248. *Id.* at 1323.
249. *Id.* The Eleventh Circuit based its analysis on *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 575 U.S. 175 (2015), which addressed opinions in what the Eleventh Circuit called "the analogous § 11 context." *Id.* at 1322.
250. *Carvelli*, 934 F.3d at 1323.
251. *Id.* at 1326.
252. 15 U.S.C. § 78u-5(c)(1)(A)(i) (2018).

the investment'" so that a buyer or seller could "'make an intelligent decision about it according to her own preferences for risk and reward.'"[253] Here, the issuer cleared that hurdle by disclosing actions pending against it at any given time, then, for example, "warn[ing] in some detail that it faced a serious risk of 'claims, litigation, and investigations' regarding its 'servicing, foreclosure, modification, origination and other practices,' [and] underscoring that the risk arose from 'uncertainty related to past, present or future investigations and settlements with state regulators, the Consumer Financial Protection Bureau . . . , State Attorneys General, the Securities and Exchange Commission . . . , the Department of Justice, or the Department of Housing and Urban Development.'"[254]

Representations about important business counterparty during repricing negotiations. In an opinion resting on the uncertain outcome of contentious negotiations, the Second Circuit affirmed dismissal of a Rule 10b-5 case against an issuer, in which the plaintiff alleged that the company made misleading statements about repricing discussions with its most important customer.[255] The issuer, Express Scripts ("Express"), acted as the exclusive pharmacy benefits manager for Anthem, Inc. ("Anthem").[256] Per their agreement, Anthem initiated a price review process in October 2014.[257] After back and forth between the two

253. *Carvelli*, 934 F.3d at 1327 (quoting Harris v. Ivax Corp., 182 F.3d 799, 807 (11th Cir. 1999)).

254. *Id*. The plaintiff argued that a cease-and-desist order "regarding violations of Rule 12b-20," *id.* at 1324 (citing 17 C.F.R. § 240.12b-20, requiring generally that, in SEC filings, information over and above that expressly required must be included where necessary in order that the required statements not mislead), took the issuer out of the forward-looking statement protections because it constituted "a judicial or administrative decree or order arising out of a governmental action that . . . prohibits future violations of the antifraud provisions of the securities laws," 15 U.S.C. § 78u-5(b)(1)(A)(ii) (2018). But the Eleventh Circuit "reject[ed] the legal premise that Rule 12b-20 constitutes an 'antifraud provision' within the meaning of" § 78u-5(b)(1)(A)(ii), reasoning that Rule 12b-20 "doesn't contain a scienter requirement." *Carvelli*, 934 F.3d at 1325.

The Eleventh Circuit similarly disagreed with the plaintiff's contention that several statements the issuer contended to be forward-looking were not properly so characterized because "they contain[ed] false statements of *present* fact." *Id.* at 1327. The court held that "when a forward-looking statement is of the sort that, by its nature, rolls in present circumstances—that is, when a statement forecasts in a tentative way a future state of affairs in which a present commitment unfolds into action—the statement isn't barred from safe-harbor protection solely on that ground." *Id.* at 1329. Thus, the court conceded the issuer's "statement that '[w]e are fully cooperating with the Department of Business oversight[,] . . . [and] expect our ongoing cooperation will result in a satisfactory outcome for all parties'" included the "present tense" statement that the company was cooperating, which "isn't entitled to safe-harbor protection simply because it is appended to a forward-looking clause." *Id.* at 1328. But the plaintiff had not "alleged facts giving rise to a strong inference that Ocwen was not cooperating with the California Department of Business Oversight." *Id.* at 1328 n.12. And the remainder of the statement—setting out an expectation that cooperation would produce a satisfactory result—was a forward-looking statement, accompanied by meaningful cautionary statements such as those recounted in the text.

In one other ruling of note, the Eleventh Circuit held that the issuer's alleged violation of 17 C.F.R. § 229.303 (Item 303 of Regulation S-K) could not support a securities fraud claim. *Id.* at 1330–31. That rule "itself doesn't seem to contemplate" a private right of action. *Id.* at 1330. Moreover, the rule could not feed into Rule 10b-5 because "the disclosure obligations imposed by Item 303 and Rule 10b-5 are materially (no pun intended) different." *Id.* at 1331.

255. *In re* Express Scripts Holdings Co. Sec. Litig., 773 F. App'x 9, 10–11, 12, 15 (2d Cir. 2019) (referring to Rule 10b-5 as the applicable law).

256. *Id.* at 11.

257. *Id.*

companies—which included mutual charges of bad faith—Anthem sued Express.[258] Investors who purchased Express common stock then sued Express, contending that Express committed fraud by making positive statements about its relationship with Anthem during the price review.[259]

The Second Circuit concluded that none of the statements were materially misleading.[260] Express's Senior Vice President of Sales and Account Management said during a conference call on February 24, 2015 that the company's relationship with Anthem was "'great,' 'very solid,' and 'business as usual.'"[261] Its Chairman and CEO stated on an April 29, 2015 conference call that Express "'really enjoys' its relationship with Anthem."[262] The Second Circuit ruled these as "expressions of puffery and optimism, and are the opinions of" the two officers that could not support a securities violation.[263] Other statements were more substantive—(i) by the Chair/CEO during the April 29, 2015 conference call that the relationship with Anthem was "a 'two-way street'"; (ii) by the Chair/CEO on December 22, 2015, that Express "was 'currently in discussions with Anthem regarding the periodic pricing provisions of the [A]greement' and 'excited to continue productive discussions,' which were 'very early on'"; and (iii) by the company in an SEC filing on February 16, 2016, saying that Express "was 'actively engaged in good faith discussions with Anthem.'"[264] The Second Circuit found these not misleading because Express "was trying to negotiate a new agreement and maintain its relationship with Anthem throughout the Class Period," including by a meeting on February 3, 2016, after which Express provided a "proposal on February 12."[265] In this context of continuing efforts and even though Anthem sent Express notices of breach that prompted the two companies to enter into a "three-step dispute resolution process" prescribed by their agreement, the challenged statements "'suggeset[ed] only the hope . . . that the talks would go well' and 'did not become materially misleading when the talks did not proceed well'"[266]—particularly in light of multiple cautions by Express "acknowledging the possibility that negotiations could fail and[, if so,] the Agreement would not be renewed."[267]

258. *Id.*
259. *Id.* The class period extended from February 24, 2015, through March 21, 2016. *In re* Express Scripts Holdings Co. Sec. Litig., 16 Civ. 3338 (ER), 2018 WL 2324065, at *1 (S.D.N.Y. May 22, 2018).
260. *Express Scripts*, 773 F. App'x at 12–13.
261. *Id.* at 13. The appellate opinion does not provide the titles for the individual defendants, but the district court decision does. *In re* Express Scripts Holdings Co. Sec. Litig., 16 Civ. 3338 (ER), 2018 WL 2324065, at *2 (S.D.N.Y. May 22, 2018).
262. *Express Scripts*, 773 F. App'x at 13.
263. *Id.*
264. *Id.* (alteration by the court).
265. *Id.*
266. *Id.* (quoting *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993)).
267. *Id.* Here is one example:

> While we are actively engaged in good faith discussions with Anthem and intend to continue to comply with the requirements of the agreement, Anthem has made public statements threatening litigation. At this time we are unable to provide a timetable or an estimate as to the potential outcome of these events, any of which could result in a material adverse effect on our business and results of operations.

Significance and analysis. It has long been the rule that a company need not disclose facts in a pejorative way.[268] But characterizing a relationship that is undergoing repricing negotiations as "solid," when in fact the issuer and the counterparty are contentiously disagreeing, seems a stretch. The lesson that counsel should draw is the wisdom of acknowledging that critical discussions are ongoing and a "two-way street," together with careful risk disclosure that a breakdown could occur and lead to materially adverse consequences.[269]

Proving materiality of a misrepresentation by testimony of a market participant. In 2018, the Second Circuit decided *United States v. Litvak*, vacating the conviction of a trader in the secondary market for residential mortgage backed securities ("RMBS").[270] During the transaction leading to his conviction, Litvak misrepresented—to the buyer of a particular RMBS security—the price his brokerage house had paid to purchase that security.[271] The Second Circuit held that since the buyer paid a price based on the markup that Litvak's brokerage received (i.e., the difference between the price that it paid for the security and the price that the buyer from it paid), Litvak's misrepresentation could be material.[272] In reaching that conclusion, the Second Circuit held a purchaser's representative could testify as to the materiality of the price, provided his testimony was "shown to be within the parameters of the thinking of reasonable investors in the particular market at issue."[273] The court nevertheless vacated the conviction because the purchaser's representative testified that he considered Litvak to be the purchaser's agent—and therefore especially credible—even though as a matter of law Litvak was not the purchaser's agent.[274] Accordingly, the testimony of this witness was "indisputably idiosyncratic and unreasonable" and could "not, therefore, [be] probative of the views of a reasonable, objective investor in the RMBS market."[275]

Express Scripts Holdings Co., Annual Report (Form 10-K), at 21 (Feb. 16, 2016).

Aside from holding that the defendants' statements did not materially mislead, the Second Circuit concluded that Express had no duty to disclose its "dispute with Anthem and the uncertainty as to the relationship between the two companies." *Express Scripts*, 773 F. App'x at 13–14. And the appellate court found that the complaint failed to allege facts raising a strong inference that the defendants had spoken or written with scienter because they "could not have known that the negotiations with Anthem would ultimately fail, especially considering the fact that the first periodic pricing review [in 2011, which therefore preceded the review that began in October 2014 and during which the defendants made the statements challenged in this action,] was successful even though it took 'approximately a year,' was 'combative,' and led Anthem to 'raise[ ] the possibility of litigation' to resolve the contractual dispute." *Id.* at 15.

268. *See, e.g.*, Dalberth v. Xerox Corp., 766 F.3d 172, 186–87 (2d Cir. 2014) (quoting *In re* Merrill Lynch Auction Rate Sec. Litig., 704 F. Supp. 2d 378, 392 (S.D.N.Y. 2010), *aff'd sub nom.* Wilson v. Merrill Lynch & Co., 671 F.3d 120 (2d Cir. 2011) (internal quotation marks omitted)).

269. *See* the quoted 10-K passage at *supra* note 267.

270. 889 F.3d 56, 59, 72 (2d Cir. 2018).

271. *Id.* at 62–63.

272. *Id.* at 67.

273. *Id.* at 65.

274. *Id.* at 67–69.

275. *Id.* at 69.

In 2019, the Second Circuit evaluated the conviction of a trader in the same RMBS market who, like Litvak, had misrepresented to counterparties prices that his brokerage was paying for particular securities, and the prices at which it could sell particular securities, in order to induce buyers and sellers to change their offers so that his brokerage would make a higher markup.[276] As in *Litvak*, the government introduced testimony from the trader's counterparties "to prove materiality" of the misrepresentations, with representatives of four of the trader's counterparties saying that they considered the trader's lies important.[277] After denying the trader's motion for a judgment of acquittal, the jury convicted the trader, and the trial court then granted the trader's motion for a new trial.[278] Reversing that order,[279] the Second Circuit remanded with an instruction to reinstate the conviction.[280]

Noting that "materiality . . . is a mixed question of law and fact" appropriate for jury determination[281] and rejecting the argument that the testimony of one counterparty representative characterized the broker as the counterparty's agent,[282] the Second Circuit found the testimony of that counterparty representative did "not misstate the law," and, considered with the testimony of the other three counterparty representatives, "was not . . . 'idiosyncratic,'" but well within the broad parameters of Federal Rule of Evidence 401, which provides that "'[e]vidence is relevant if: (a) it has any tendency to make a fact more or less probable than it would be without the evidence; and (b) the fact is of consequence in determining the action.'"[283] For that reason, the appellate court held that "[t]he district court . . . properly applied our [*Litvak*] holdings . . . in denying [the trader's] motion for judgment of acquittal."[284] The testimony of this counterparty was admissible as relevant to materiality.[285]

Turning then to the motion for new trial, the Second Circuit saw this as a question under Federal Rule of Evidence 403, which "provides for the exclusion of relevant evidence 'if its probative value is substantially outweighed by a danger of one or more of the following: unfair prejudice, confusing the issues, misleading the jury, undue delay, wasting time, or needlessly presenting cumulative evidence.'"[286] Here that translated into whether the admission of the counterparty representatives' testimony—that they attributed importance to the defendant's

276. United States v. Gramins, 939 F.3d 429, 435–40 (2d Cir. 2019). Market participants called the markup a "commission," "pay on top," or "spread." *Id.* at 436.

277. *Id.* at 440, 446.

278. *Id.* at 443.

279. *Id.* at 434, 457.

280. *Id.* at 457.

281. *Id.* at 446.

282. *Id.* at 449–50. For example, the court observed that "[n]owhere in the record . . . does [the counterparty's representative] state that he believed that Gramins was his agent, nor that Gramins owed him fiduciary duties." *Id.* at 449.

283. *Id.* at 449–50 (quoting FED. R. EVID. 401).

284. *Id.* at 447.

285. *Id.* at 450. This conclusion also therefore applied to the testimony of the other three counterparty representatives.

286. *Id.* at 451.

misrepresentations—gave the government "an unfair advantage in pressing [its] theory [of materiality] to the jury."[287] The Second Circuit concluded that the counterparty testimony did not "advance the government's theory . . . impermissibl[y]."[288] Instead, it left the materiality issue in equipoise, with (i) the government offering its proof of materiality through the testimony of counterparties that was not idiosyncratic but within the parameters of a reasonable investor in the particular market and (ii) the defense offering its proof "that, in a market full of sophisticated investors relying largely on complex models, no reasonable investor would have credited broker-dealers' representations about RMBS prices."[289] Specifically, the testimony that the government offered did not "unduly prejudice, mislead, or confuse the jury under FRE 403."[290]

Particularity of pleading omissions of illegal conduct. Rule 9(b) requires that "[i]n alleging fraud . . . , a party must state with particularity the circumstances constituting fraud or mistake."[291] The special pleading rules added by the PSLRA for private lawsuits under the Exchange Act require that, where the plaintiff "alleges that the defendant—(A) made an untrue statement of a material fact; or (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading . . . the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint *shall state with particularity all facts on which that belief is formed*."[292]

The *Gamm v. Sanderson Farms, Inc*. plaintiff alleged that Sanderson violated Rule 10b-5 by failing to disclose its participation in a price-fixing conspiracy.[293] That participation allegedly made false or misleading statements in the company's SEC filings that it competed with other firms.[294] The Second Circuit affirmed dismissal of the securities case, on the principle that "when a securities fraud complaint claims that statements were rendered false or misleading through the nondisclosure of illegal activity, the facts of the underlying illegal acts must be pleaded with particularity in accordance with the requirements of Rule 9 and the PSLRA."[295]

The court of appeals reasoned that the "nondisclosure and material omission claims are entirely dependent upon the predicate allegation that Sanderson

287. *Id*. at 447.
288. *Id*. at 451.
289. *Id*. at 446.
290. *Id*. at 453. The Second Circuit noted that "the prosecutors actively took steps to disabuse the jury of any mistaken notion that [the defendant] acted in a fiduciary capacity." *Id*. at 455.
291. FED. R. CIV. P. 9(b).
292. 15 U.S.C. § 78u-4(b)(1) (2018) (emphasis added).
293. 944 F.3d 455, 458–61 (2d Cir. 2019). Chicken producers and consumers filed antitrust civil lawsuits against Sanderson. *Id*. at 460. At least one financial analyst downgraded Sanderson stock from hold to sell, concluding that allegations in the lawsuits were "'powerfully convincing.'" *Id*. *The New York Times* and *Washington Post* ran stories about chicken prices. *Id*. at 460–61. Sanderson's stock price declined. *Id*.
294. *Id*. at 460.
295. *Id*. at 466–67.

participated in a collusive antitrust conspiracy,"[296] and that "the basic elements of an underlying antitrust conspiracy, . . . are: '(1) a contract, combination, or conspiracy; (2) in restraint of trade; (3) affecting interstate commerce.'"[297] The complaint failed to plead facts to show the first element because it contained "virtually no explanation as to how that collusive conduct occurred."[298] Instead, the pled facts showed "mere parallel conduct, and lack indicia of mutuality or otherwise interdependent action."[299] In particular, the complaint failed to allege "*when* Sanderson Farms decided on its course of supply reduction, which industry peers were a part of that decision, *how* specific supply reductions were performed by each of the different poultry producers, *what* information Sanderson Farms knew about its peers' supply reductions, if any, and—perhaps most basic of all—whether Sanderson Farms *actually reduced* chicken supply, and if so, by what volume."[300] The Second Circuit then observed that the complaint contained no allegations whatsoever regarding the second and third elements of the supposed price-fixing violation.[301]

Significance and analysis. *Sanderson* stands out due to its emphasis on the elements of the asserted underlying legal violation. As the Second Circuit analyzed it, the complaint itself invited this focus by charging that the defendant had actually committed a price-fixing violation. That structured view produced the conclusion that the securities plaintiff had to plead specific facts to show both the antitrust violation and the securities violation. This suggests that, whenever a securities plaintiff alleges illegality material to an issuer's stock price, that plaintiff must identify the particular law the issuer's conduct violates, then plead specific facts to show that the issuer's conduct, and resulting effects, satisfy every element of that violation.

Taken literally, that burden seems excessive. Conduct that does not quite satisfy all elements of a legal violation can still land an issuer in such trouble that its revelation will adversely affect its stock price. For example, suppose that a company employs an extremely effective sales tactic. Government regulators do not like the tactic. They investigate and bring one or more enforcement actions. Even though the company believes that the tactic is legal, it settles with the regulators with a promise to forgo the tactic going forward. The regulators are happy with this settlement because they too question whether, in the end, they could prove a case against the issuer because their evidence on one or more elements is shaky. But the issuer's sales and profit suffer because it stops the effective sales tactic, and, accordingly, its stock price declines.

Should the securities plaintiff who sues on the basis that the sales tactic was not disclosed lose simply because the plaintiff could not (as the regulators questioned whether they might not) prove every element of the legal violation the

296. *Id.* at 463.
297. *Id.* at 465 (quoting Maric v. St. Agnes Hosp. Corp., 65 F.3d 310, 313 (2d Cir. 1995)).
298. *Id.*
299. *Id.*
300. *Id.* at 465–66.
301. *Id.* at 466.

regulators charged but settled? Perhaps a plaintiff in such a case is best advised to plead nondisclosure of the sales tactic rather than nondisclosure of a legal violation, with the materiality of the tactic analyzed by the probability/magnitude test, using the probability of various regulatory outcomes (including a settlement in which the issuer forswears continuing the tactic) and the magnitude of each outcome in relation to overall company operations.[302]

Life sciences cases. After the Food and Drug Administration ("FDA") approves a drug and a company begins to sell it, independent medical researchers or physicians may contact the company and report instances in which patients taking the drug developed adverse conditions, and individual employees within the company may conclude that the drug creates risks to patients that labeling does not reveal. Both the First and Ninth Circuits affirmed dismissal of Rule 10b-5 claims against drug manufacturers based on statements executives made after their companies received such reports or after an employee reached such a conclusion.

Investors in *Metzler Asset Management GmbH v. Kingsley* asserted an Exchange Act section 10(b) claim against Biogen, Inc. ("Biogen") and executives for statements made from July 23, 2014, through July 23, 2015, concerning the sales of Biogen's drug Tecfidera, which was designed to treat multiple sclerosis ("MS") and provided Biogen one-third of its revenue.[303] Importantly, Biogen announced on October 22, 2014, that a patient taking Tecfidera had died of progressive multifocal leukoencephalopathy ("PML").[304] In November, the company added a warning about PML to Tecfidera's label.[305] Although Biogen publicly projected on January 9, 2015, that the company's revenue would grow during 2015 by 14 percent to 16 percent, Biogen lowered that forecast on July 24, 2015, to 6 percent to 8 percent.[306] Its stock price fell by 20 percent.[307]

Affirming dismissal,[308] the First Circuit addressed two statements about Tecfidera's safety and four concerning the drug's usage rate—considering in each analysis whether the complaint alleged both facts to show that the statements misled and facts raising a strong inference that the defendants intended to deceive.[309] As to safety, (i) Biogen's Chief Medical Officer (who was not a defendant) stated on September 11, 2014, that Tecfidera was "supported by a growing

302. *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988), prescribed this test as appropriate to analyze the materiality of events suggesting that a merger or acquisition will occur. But it can also be helpful in evaluating the significance of government investigations. *See* Statement of the Commission Regarding Disclosure Obligations of Companies Affected by the Government's Defense Contract Procurement Inquiry and Related Issues, 53 Fed. Reg. 29226, 29227 (Aug. 3, 1988) ("The potential effects of the government's inquiry must be discussed in the Management's Discussion and Analysis of Financial Condition and Results of Operations ('MD&A') in a company's annual and quarterly reports as well as transactional filings if, in light of the associated probabilities and magnitudes, the effects may be material.").

303. 928 F.3d 151, 154, 158 (1st Cir. 2019) (indicating that claim rested on section 10(b)).

304. *Id.* at 154.

305. *Id.*

306. *Id.* at 154–55.

307. *Id.* at 155.

308. *Id.* at 166.

309. *Id.* at 159–62.

body of data reinforcing its benefits and favorable safety profile" and (ii) Biogen's Executive Vice President of Research and Development (also not a defendant) stated in April 2015 that "there's no real change in the benefit/risk profile of the drug for patients with MS. So it's pretty much status quo at the moment."[310] The plaintiffs contended that the first statement was knowingly false because Dr. Thrower, the medical director of the Shepard Center in Atlanta, told Biogen's senior sales director and its medical science liaison in August and September that his (Thrower's) "research showed that patients who were taking Tecfidera had a higher risk of developing low lymphocyte counts than Biogen had originally disclosed."[311] But given "the limited slice of the market" covered by Thrower's research, it did not contradict the statement that Biogen's Chief Medical Officer made, nor did it support a strong inference that the Biogen officer "spoke with the intent to deceive investors."[312] As to the second Biogen statement, the "status quo" it referenced included the PML death that Biogen had disclosed, as well as the revised Tecfidera label warning of PML danger.[313] Because "none of the findings by the researchers that the plaintiffs cite aver that the drug was less safe than these revised disclosures," the court did "not see how the plaintiff[] can plausibly suggest that [Biogen's Executive Vice President of Research and Development] was aware that the drug was less safe than these revised disclosures suggested."[314]

Turning to statements about Tecfidera's usage rates, the First Circuit analyzed four statements made by Biogen's Executive Vice President of Global Operations: one on January 29, 2015, that "'Tecfidera [was] on track to become the most prescribed therapy for MS worldwide,'" and three statements from late January 2015 through late February 2015, in which the executive said "that there had not been any 'meaningful change' in Tecfidera's discontinuation rates and that those rates were 'consistent with historical averages.'"[315] The appellate court found the opinion that Tecfidera would "become the most prescribed therapy for MS worldwide" nothing more than "misguided optimism" from which it could not draw a strong scienter inference given that, by the time the executive made the statement, "Biogen had already disclosed to the public the news of the PML death, had already changed the drug's label, had already publicized that it expected the drug's growth rate to 'slow,' and had already disclosed that the drug's discontinuation rates were higher than expected."[316] Resting the conclusion on these same disclosures and Biogen's expressed hope "that the company aimed to 'get better performance in the discontinuation rates over a longer period of time,'" the court could not see how the executive's "early 2015 refrain that the

310. *Id.* at 158–60.

311. *Id.* at 159 (with the plaintiff also alleging that Thrower told the two Biogen contacts that he had discontinued Tecfidera prescriptions for about 200 of his patients and had ceased to write new prescriptions for the drug).

312. *Id.* at 159–60.

313. *Id.* at 160.

314. *Id.*

315. *Id.* at 160–61.

316. *Id.*

company had not seen 'meaningful change' in the drug's discontinuation rate and that the rates were 'consistent with historical averages' may fairly be characterized as having been made with the 'intent to deceive.'"[317]

Having dispatched the complaint on this traditional analysis, the First Circuit then proceeded to plaintiffs' contention that they should be permitted to proceed on the theory "that, if the complaint plausibly alleges that one of the company's employees made a misleading statement to investors without scienter and 'an individual within Biogen's management team . . . knew or had access to information' that showed that this misleading statement was not true, then Biogen [could] be found to have had the requisite scienter on a corporate scienter theory."[318] The appellate court found the complaint did not raise a "strong inference" of the requisite state of mind, "even if [the court] were to accept [this] theory of corporate scienter."[319] As to Dr. Thrower's communications with two persons at Biogen, "the fact that Dr. Thrower and [other researchers] concluded on the basis of their own research that Tecfidera could cause lower lymphocyte counts than was originally understood does not, in and of itself, suffice to contradict the assertions that Tecfidera was 'effective' at treating MS and that this fact was 'supported by a growing body of research.'"[320] Nor did Dr. Thrower's communications "show that the company knew that the drug's usage rates were lower than was publicized[, as] [the court] fail[ed] to see how the knowledge that one doctor—whose patients constituted less than 0.2 percent of all Tecfidera users—would no longer prescribe Tecfidera could suffice to show that the company understood the drug's usage rate to be at odds with any statement regarding its usage that had been made publicly."[321] As to whether the various statements by confidential witnesses raised "corporate scienter" with respect to the challenged statements about Tecfidera's usage and discontinuation rates, those statements showed only that "employees in the company were concerned about the impact the PML death would have on Tecfidera sales," but did "not create a 'strong inference' that someone in the company's management team knew that [the Biogen Executive Vice President of Global Operations'] generalized statements about the drug's discontinuation rates were untrue."[322]

317. *Id.* at 161. The plaintiff also alleged that numerous confidential witnesses had provided statements "regarding their observations on Tecfidera's sales, discontinuation rates, and safety profile." *Id.* But these did not affect the First Circuit's scienter analysis because they did not provide specific facts contrary to the six challenged representations nor did the complaint assert that any of these witnesses "ever spoke with any of the individual defendants or otherwise shared with them their observations." *Id.* While the plaintiff also contended that "Biogen's leadership monitored Tecfidera's reporting metrics" and that therefore the Executive Vice President of Global Operations' statements about Tecfidera's discontinuation rate were knowingly false, the First Circuit said that it "expect[ed] responsible management to engage in such monitoring," but that "before one could infer what plaintiffs ask, one would need to know what [the executive] learned from such monitoring, and whether what he learned was at odds with any of his 'plausibly misleading' statements." *Id.* at 162.

318. *Id.* at 162.

319. *Id.* at 163.

320. *Id.*

321. *Id.*

322. *Id.* at 164. The plaintiffs unsuccessfully invoked the "core operations" theory by which information about such operations is imputed to top executives for scienter analysis. *Id.* at 165. That the-

Authored by the Ninth Circuit, *In re Arrowhead Pharmaceuticals, Inc. Securities Litigation*, affirmed dismissal of a Rule 10b-5 case on a somewhat similar set of facts centering on two sets of statements and one failure to disclose.[323] As to the first set of statements—"purportedly downplaying [a drug's] toxicity risks"—the complaint pled only one statement by one former employee "to establish dose accumulation toxicity," not enough without "corroborating details nor other facts" to show that what the company said was false.[324] Moreover, the complaint failed "to specifically allege that Defendants knew any of their [toxicity] statements were materially misleading."[325] As to the second set of statements—respecting a partial clinical hold on a multi-dose study—the complaint did not support its conclusion that the defendants omitted to state that the FDA imposed the hold *because* of concerns over the drug's toxicity, as the complaint failed to include "specific allegations" that the FDA, in fact, "concluded that the drug posed an unreasonable health and safety risk."[326] Moreover, because the plaintiff "ha[d] not sufficiently alleged that Defendants *knew* about the FDA's alleged reason for imposing the hold, [the] Plaintiff . . . failed to allege scienter."[327] As to the failure to disclose, before November 2016, non-primate deaths during a toxicity study, the plaintiff pled the dates of the deaths too broadly as "'late 2015 or early 2016,'" and failed as well "to allege who at Arrowhead knew about the deaths."[328] Finally, an overarching argument—that the defendants' false statements and omission were motivated by their desire "to secure 'a critical, lucrative collaboration deal with Amgen' and to raise $43.2 million in a secondary offering in August 2016"—added nothing because "allegations of routine corporate objectives such as the desire to obtain good financing and expand are not, without more, sufficient to allege scienter."[329]

Significance and analysis. In 2011, the Supreme Court rejected the analysis that adverse outcomes by patients taking drugs could not be material, for securities law purposes, unless the incidence of such adverse outcomes was statistically significant.[330] This left open the possibility that a drug company could be sued for securities fraud, in actions that would survive at least into discovery, on the basis that anecdotal reports conflicted with company statements—even if the anecdotal reports involved so few patients that they did not show

ory only operates when the guilty knowledge is somewhere in the company, and "plaintiffs fail[ed] to identify any allegations in the complaint that show that anyone in the company had knowledge regarding the drug's safety profile and sales that contradicted the company's public representations." *Id.* Plaintiffs' theory that top officers had guilty knowledge because Biogen operated in a "highly regulated industry" suffered "from the same defect." *Id.* at 166.

323. 782 F. App'x 572, 574–75 (9th Cir. 2019).

324. *Id.*

325. *Id.* at 575.

326. *Id.*; *In re* Arrowhead Pharm., Inc. Sec. Litig., Case No. CV 16-08505 PSG-PJW, 2017 WL 8791111, at *4 (C.D. Cal. Dec. 21, 2017) ("Plaintiffs argue . . . statements by Defendant concealed that the FDA had placed a partial hold on the clinical trials because of 'concerns over toxicity.'").

327. *Arrowhead*, 782 F. App'x at 575.

328. *Id.*

329. *Id.* (quoting plaintiffs in the first instance and *In re* Rigel Pharm., Inc. Sec. Litig., 697 F.3d 869, 884 (9th Cir. 2012) in the second).

330. Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 40–43 (2011).

a statistically significant association between a negative side effect and the company's drug. The same risk loomed with respect to company employees. If one of them concluded—even without data showing a statistical link—that a drug might produce an adverse side effect not already included on a warning label, a plaintiff's lawyer who found the employee and quoted him or her in a complaint might sustain a Rule 10b-5 claim against the company, at least past the pleading stage.

The two 2019 cases assuage this concern to some extent. Where the statement is general—e.g., that "a growing body of data reinforc[es a drug's] benefits and favorable safety profile"—the anecdotal evidence of adverse outcomes displayed by a limited number of patients (in *Kingsley*, less than 0.2 percent of all patients taking the drug) may not show that it is false at all, let alone that the speaker or author knew it was false or was reckless in not knowing that.[331] Second, once the company discloses an incident in which a patient taking the company's drug has suffered a severe outcome, that announcement—and any resulting change in the drug's warning label—become part of the "total mix of information" against which the falsity of a statement, particularly a general one, is measured.[332] Thus, the disclosed death of a patient and consequent label change in *Kingsley* meant the executive's statement that the "benefit/safety profile of the drug" had experienced "no real change" but remained at "status quo" was not false because, by the time he made that statement, the total mix of information already included the death that had occurred and the consequent label warning.[333] And, as in other contexts, a company's disclosure of adverse events argues generally against a plaintiff's claim that a company or its executives were deliberately trying to deceive investors as to a drug's safety.[334]

The same analysis applies to conclusions by individual employees at a drug company about adverse side effects or the commercial consequences of those effects. In addition, the conclusions of individual employees may never reach the executives who make the challenged statements and, if they do not, will not show that those executives intended to deceive.[335]

Insider trading. The Fifth Circuit last year listed the elements of a tipper violation and found sufficient evidence introduced on each one to sustain a conviction.[336] The First Circuit affirmed a tipper's conviction under the misappropriation theory because sufficient evidence showed that he owed a duty of loyalty and confidence to the source of his information—his wife—and a jury could have concluded that his wife had not waived that duty.[337] The Second Circuit determined that the prosecution presented evidence in a trial to show that a

331. *See supra* notes 310–12, 321, and accompanying text.
332. *See supra* note 171 and accompanying text.
333. *See supra* notes 310, 313, 314, and accompanying text.
334. *See supra* notes 316, 317, and accompanying text.
335. *See supra* notes 322, 325, and accompanying text.
336. *See infra* notes 339–65 and accompanying text.
337. *See infra* notes 366–91 and accompanying text.

tipper had sufficient understanding that his tip—made to his financial adviser—would lead to trading.[338]

Elements of a tipper violation. The tipper in *United States. v. Xie* worked in the five-person Financial Planning & Analysis Group ("FP&A") at The Shaw Group ("Shaw").[339] Chicago Bridge & Iron, N.N. ("CB&I")—at times in conjunction with Toshiba, but ultimately proceeding by itself—expressed interest in acquiring Shaw in March 2012 and, after completing due diligence, announced an agreement on July 30, 2012, to do so.[340] Ms. Xie "took an active role in obtaining Shaw's financial information to satisfy CB&I's due diligence requests."[341] A jury convicted her of tipping her live-in boyfriend to the acquisition, as well as their neighbor, and the neighbor's older brother.[342] Affirming the conviction against her challenge that the prosecution presented insufficient evidence to support the charges,[343] the Fifth Circuit set out the "six elements required to convict a tipper of insider trading: (1) that the defendant disclosed material, nonpublic information to another person, (2) that the disclosure was made for [a] personal purpose in breach of the defendant's fiduciary duty as a corporate insider, (3) that the defendant anticipated that the other person would trade on the basis of the information, (4) that the other person unlawfully traded, (5) that the defendant acted knowingly, willfully, and with the intent to defraud, and (6) that the insider trading scheme involved the use of some instrumentality of interstate commerce."[344]

As to the first element, Ms. Xie contended the evidence showed only her "*potential* access to" material nonpublic information, not her actual possession of it.[345] But (i) she "received CB&I and Toshiba's 22-page due diligence request for 'Project Jewel,' a code name for the acquisition"; (ii) the Shaw CFO testified "that a member of FP&A 'could easily have inferred' from the due diligence requests that a company was seeking to purchase Shaw"; (iii) FP&A ran repeated out-of-cycle projections of Shaw's intrinsic value, using a Morgan Stanley model in May and June 2012; (iv) a co-worker in FP&A "testified that based on these [unusually timed] updates he believed Shaw was selling itself and assumed [Ms. Xie], who had this same information, believed the same"; (v) a second FP&A co-worker testified that the FP&A Manager told the FP&A team "about CB&I's pending acquisition of Shaw prior to the announcement"; and (vi) Ms. Xie "discussed the acquisition at length," with that co-worker, who feared for her

338. *See infra* notes 392–402 and accompanying text.

339. 942 F.3d 228, 232 (5th Cir. 2019). The opinion notes that Ms. Xie was "generally known" as Kelly Liu, and the court of appeals uses "Liu" throughout its decision. *Id.* at 232 n.1. This summary uses Ms. Xie's formal name.

340. *Id.* at 232.

341. *Id.*

342. *Id.* at 232–33. A jury convicted Ms. Xie of two counts of securities fraud and one count of conspiring to commit securities fraud. *Id.* at 232.

343. *Id.* at 232, 234, 241.

344. *Id.* at 234.

345. *Id.*

continued employment at Shaw if the deal went through and ultimately left Shaw, with Ms. Xie knowing "why [her co-worker] was leaving and agree[ing] with her decision."[346] Taken together, the Fifth Circuit held that this "evidence . . . provided the jury with a sufficient basis to conclude that [Ms. Xie] *actually possessed* information about the impending sale of Shaw."[347]

Further contesting the first element, Ms. Xie argued that "she did not know the price or other details of the deal" and therefore did not have *material* non-public information.[348] The Fifth Circuit, however, held that "materiality in this instance does not demand that the tipper know all the details of the proposed transaction."[349] Since Ms. Xie knew of the 22-page due diligence request and the involvement of investment bankers, "the jury had sufficient evidence to conclude that the information was material" because she knew that "talks of an acquisition were far beyond speculation" and, when she passed news of the deal to her tippees, her status as an insider at the target company gave the information she imparted special credibility.[350] Moreover, the information was nonpublic, as "[d]irectors of both companies testified that they used code names, had access-controlled electronic data rooms, and executed confidentiality agreements."[351]

While the opinion points to no evidence specifically identifying the information Ms. Xie told to her putative tippees, the jury "was entitled to find the timing of the communications revealing."[352] "The highest volume of phone communications between [Ms. Xie] and [her neighbor] in 2012 occurred in July, the most notable days being July 18, 19, and 30," the day the takeover was announced, and "the highest volume of phone communications" between her neighbor and his brother occurred in July 2012, "peaking on July 19 (when [the brother] first ordered Shaw call options)."[353] In addition, "a device [Ms. Xie] regularly accessed" "logged on to [the brother's] brokerage account" "and researched Shaw call options" at the very time that the brother was talking to his broker—from which "[t]he jury could infer [she] was the user who logged into the account to assist [the brother] in purchasing the call options."[354] As to her live-in boyfriend, she and he "exchanged a series of phone calls and texts" on July 18, immediately after which the boyfriend "called his mother and asked permission to buy Shaw stock in her brokerage account, explaining he knew of rumors of an acquisition."[355] This coincidence of Ms. Xie's communication with the traders

346. *Id.* at 234–35 & n.14 (emphasis added).
347. *Id.* at 235 (emphasis added).
348. *Id.* at 237.
349. *Id.*
350. *Id.*
351. *Id.*
352. *Id.*
353. *Id.* at 237–38.
354. *Id.* at 238.
355. *Id.* The "mother testified to a grand jury that [Ms. Xie] admitted to her that she passed on the information about the pending Shaw buyout." *Id.* at 238 & n.33 (explaining why this testimony was admissible for substantive purposes).

and their trades "was . . . sufficient for the jury to find that [she] passed on to [her neighbor] and [his brother] her knowledge about the pending acquisition of Shaw."[356]

Moving to the second element, Ms. Xie did "not contest" that she was a corporate insider with a consequent duty of confidentiality. Regarding a personal benefit from breaching that duty by her disclosures, Ms. Xie further conceded that "she 'had a close personal relationship with [her boyfriend] and [her neighbor] in July 2012' that '[a]s a matter of law . . . [was] sufficient to infer a personal benefit if [she] disclosed material nonpublic information [to them] for securities trading purposes.'"[357]

While Ms. Xie argued proof was insufficient on the third element—contending "that, if anything, she told [her boyfriend] *not* to trade Shaw stock"—"[t]he jury was entitled to find that, because [she] was researching Shaw call options from [the neighbor's brother's] account apparently to assist in purchasing the options, she understood precisely what [the brother] was in the process of doing: purchasing Shaw call options based on the information she furnished him about Shaw's potential acquisition."[358] Moreover, since the brother specifically "asked his broker if he could sell his options on July 30, the date that CB&I announced its purchase of Shaw," the jury could have reasonably found that Ms. Xie "conveyed the approximate date of the acquisition to [him], so he could purchase and sell Shaw options on the most advantageous dates."[359]

Considering the fourth element, the government showed that both Ms. Xie's boyfriend (through his mother's account "in which he had a beneficial interest") and the neighbor's brother traded in Shaw stock and options.[360] The evidence sufficed for the fifth element—which the court of appeals labeled "scienter"[361]—because it showed that Shaw had specifically trained Ms. Xie "on insider trading and handling confidential corporate information" and sent her "quarterly emails reminding her of this policy," which "explicitly stated she could not 'pass on to others' any material, nonpublic information."[362] The fact that Ms. Xie "lied to the FBI and IRS in 2014, claiming that she did not know about the merger prior to the announcement, despite having been emailed that the acquisition cleared the day before" provided further proof that she knew what she had done was wrong.[363] Finally, Ms. Xie did not contest that the

356. *Id.* at 238.

357. *Id.*

358. *Id.* at 239.

359. *Id.*

360. *Id.*

361. The government prosecuted Ms. Xie under Exchange Act sections 10(b) and 78ff. *Id.* at 232. Accordingly, it had to prove (i) the elements of a 10(b) violation, including "the requisite scienter to commit securities fraud" and, (ii) in order to convict criminally under § 78ff, that she committed the section 10(b) violation "willfully"—"with the specific intent to either disobey or disregard the law." *Id.* at 239. The court of appeals found the evidence set out in the text sufficient to support a jury finding of both.

362. *Id.* at 239; 15 U.S.C. § 78ff(a)(2018) (relevant because this was a criminal case; requiring that the defendant "willfully violate[]" the Exchange Act).

363. *Xie*, 942 F.3d at 239.

government proved the sixth element—use of an instrumentality of interstate commerce—as use of "a telephone, the internet, mail, or the facilities of a national securities exchange" meets that requirement.[364]

Significance and analysis. *Xie* includes a helpful, element-by-element walk-through showing how to prove an insider trading case against a tipper. If a prosecutor were constructing an outline of what he or she needed to prove, however, it might be helpful to disentangle the several parts of what the Fifth Circuit includes in its first element so: (i) the information must be material, (ii) it must be nonpublic, (iii) it must be in the actual possession of the tipper, and (iv) the tipper must disclose it. The fifth element might benefit from disaggregation as well. To prove scienter, the government must show that (i) the defendant knew (or in a civil case was at least reckless in not knowing) that he or she had a duty not to disclose the information to others for personal benefit, (ii) the defendant knew (or in a civil case was at least reckless in not knowing) that the information was material, and (iii) the defendant knew (or in a civil case was at least reckless in not knowing) that the information was nonpublic.[365] While it is possible to subsume all of these into the tipper's knowledge that he or she would violate a duty by disclosing—on the reasoning that the duty only applies to information that is both material and nonpublic—a checklist for proof at trial will be more helpful if broken down into subcategories so that trial evidence covers all necessary proof.

Tipper's duty of loyalty and confidence to the source of the tipper's information. There are two principal theories of insider trading and tipping under Rule 10b-5: the classical theory and the misappropriation theory.[366] The classical theory posits that the corporate insider at the company whose stock is traded owes a duty—to the shareholders of that issuer and to that issuer—not to use the information for personal gain and violates that duty by tipping the information, for personal gain, to someone who will trade on it.[367] The misappropriation theory posits that anyone—whether a corporate insider or not—who owes a duty of trust and confidence to the source of information violates that duty by tipping the information, for personal gain, to someone who will trade on it.[368] The *Xie* opinion proceeds on the classical theory, stressing that "Shaw considered [Ms. Xie] an 'insider' and provided her and others in her department the company's policy on insider trading";[369] "[t]he Government had to demonstrate that [Ms. Xie] disclosed this aforementioned information for a personal purpose in breach of her fiduciary duty as a

364. *Id.* at 240.

365. *See* SEC v. Obus, 693 F.3d 276, 286 (2d Cir. 2012) (describing the "requisite scienter" to include that "the tipper must know that the information that is the subject of the tip is non-public and is material" and that "the tipper must know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty").

366. United States v. O'Hagan, 521 U.S. 642, 651–53 (1997).

367. *Id.* at 651–52.

368. *Id.* at 652.

369. *Xie*, 942 F.3d at 232.

corporate insider";[370] and Ms. Xie "does not contest that she was a corporate insider."[371]

In *United States v. Kanodia*, the First Circuit affirmed the conviction of a tipper where the government proceeded on the misappropriation theory.[372] The defendant learned from his wife—who was the chief legal officer of Apollo Tyres ("Apollo")—that Apollo was going to acquire Cooper Tires ("Cooper").[373] He disclosed the information to two friends, expecting that they would trade on it and pay some of their trading profits to him.[374] His friends bought Cooper stock and call options and, indeed, paid some of their resulting trading profits to the defendant when they sold these securities following the acquisition announcement and a subsequent 40 percent increase in Cooper's stock price.[375]

On appeal, the defendant argued that the government had not presented sufficient evidence to support the jury's conclusion that his tipping violated any duty of trust or confidence that he owed to his wife because their relationship did not display "a 'history, pattern, or practice of sharing confidences.'"[376] The First Circuit concluded that "the jury could have credited the wealth of testimony indicating that [the defendant] and [his wife] not only shared confidences in the history of their marriage, but also in their business and career advisory relationships."[377] Particularly focused on the information at issue, his wife allowed the defendant to stay with her in a hotel suite in New York City at a time when she was conducting due diligence on the Cooper deal, thereby risking that he would see confidential information about the acquisition—a circumstance from which the defendant, "an entrepreneur with an MBA, was sophisticated enough to know" that his wife was required to keep such information private and expected him to do so too.[378] While the defendant contended that his wife's own conduct—by telling others outside Apollo that she was working on the deal—showed that any duty of trust and confidence between him and his wife did not extend to information on the acquisition, the First Circuit concluded that his wife's comments to others constituted only "boasts" that referred to the transaction "in general terms"[379] and did not include "the specific details as

370. *Id.* at 238.

371. *Id.* In addition, the Fifth Circuit began its analysis by citing *Dirks v. SEC*, 463 U.S. 646, 659, 662 (1983), *Xie*, 942 F.3d at 233–34, which was decided long before the Supreme Court recognized the misappropriation theory in *O'Hagan*. *See supra* note 366.

372. 943 F.3d 499, 504, 514 (1st Cir. 2019).

373. *Id.* at 503.

374. *Id.* at 503–04.

375. *Id.*

376. *Id.* at 506 (quoting United States v. Parigian, 824 F.3d 5, 14 (1st Cir. 2016), in turn quoting 17 C.F.R. § 240.10b5-2(b)(2), a regulation that the SEC advised, in a Preliminary Note, "provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the 'misappropriation' theory of insider trading under Section 10(b) of the Act and Rule 10b-5"). *Kanodia* acknowledged that "other circuits have held that a marital relationship, standing alone, is insufficient to show a history, pattern, or practice of sharing confidences." *Id.* at 506.

377. *Id.* at 506.

378. *Id.* at 506–07.

379. *Id.* at 507. At another point in the decision, the court elaborated: "During her stay in New York, [the defendant's wife] disclosed to two acquaintances that she was in New York to negotiate

to price and timing" that one of the defendant's friends testified that he received from the defendant and on which the friend relied in buying Cooper securities.[380]

Because this was a criminal case, the government proceeded not only under Exchange Act section 10(b) and related Rule 10b-5 but also section 32(a), which provides criminal penalties, but only when a defendant violated a substantive Exchange Act section "willfully."[381] The court of appeals found sufficient evidence from which the jury could have found this element because the jury "heard strong circumstantial evidence showing that [the defendant] acted with knowledge that his scheme violated the law."[382] For example, the defendant hid the kickbacks from both of his friends by arranging that they be paid into an account the defendant created in the name of a charitable foundation.[383]

In addition to his sufficiency of evidence argument, the *Kanodia* defendant challenged jury instructions, with two worth attention here. First, he contested the instruction that, to prove "a trade was on the basis of material, nonpublic information, '[a]ll that is required is that [the defendant's friends] were in possession of the material nonpublic information at the time that they traded.'"[384] The First Circuit held that, if this was error, it was harmless, as one of the defendant's friends "testified that he relied on [the] tips to trade," both friends sometimes traded shortly after phone calls with the defendant, and both paid kickbacks to the defendant from profits on their trades—all of which went to proving that they used the information from the defendant for their trades.[385] Second, the defendant argued the trial court should have given an instruction that the government had to prove his wife had not waived any duty of confidentiality that he owed to her with respect to information about the Cooper deal.[386] But the defendant pointed to no authority holding that the government was required, as part of its case, to rebut such a defense.[387] Moreover, a jury could have rejected a waiver argument because his wife's disclosures to others did not include the details on price and timing that the defendant passed on to his tippees.[388]

Significance and analysis. In rejecting the defendant's position that the trial court should have instructed the jury that his wife might have waived any otherwise applicable duty of trust and confidence, the First Circuit commented that "the insider cannot waive the duty."[389] This is analytically confusing without

Apollo's purchase of a company, in violation of Apollo's confidentiality policy. Both of [her] disclosures occurred in [the defendant's] presence." *Id.* at 503.

380. *Id.* at 507. In addition to noting that these remarks may have conveyed information too general to constitute a breach of duty, "the jury reasonably could have concluded that [the defendant's wife] disclosed information with the understanding that her acquaintances would keep the information confidential." *Id.*

381. *Id.*; 15 U.S.C. § 78ff(a) (2018).

382. *Kanodia*, 943 F.3d at 507.

383. *Id.* at 504, 507–08.

384. *Id.* at 509–10 (first alteration by the court).

385. *Id.* at 510.

386. *Id.* at 510–11.

387. *Id.* at 511.

388. *Id.* at 507, 511.

389. *Id.* at 511.

elaboration. The defendant's wife was an Apollo insider. She had duties to her company—under both the misappropriation and classical theories—not to pass on material nonpublic information about the acquisition to others under circumstances reasonably likely to lead to trading on the information. Respecting her duty to her company, as the source of her information under the misappropriation theory, she could not waive that duty. Only her company could do so. And she could not waive a duty that her husband owed to her due to their own relationship of trust and confidence, since *that* duty—with respect to the information about the acquisition—derived from her duty to her company.[390] Respecting his wife's duty to her company *and its shareholders* under the classical theory, even her company could not have waived that duty, because even her company—itself an insider—could not trade or tip under the classical theory.[391]

Tipper's understanding that the tip will lead to trading. The Second Circuit affirmed in *United States v. Klein* the conviction of a tipper who appealed an order denying his motion for acquittal at the close of the government's case on the ground that the prosecution had not presented evidence that he intended his tippee to trade on information the tipper had acquired, through his legal practice, that Pfizer was going to acquire King pharmaceuticals.[392] Granting that whether the tipper "intend[ed] that the tippee use the information to improperly trade in securities" was a "critical question" because "'the government must prove as an element of the offense that the tipper conveyed material nonpublic information to his "tippee" with the understanding that it would be used for securities trading purposes,'"[393] the court recounted the defendant's story that he had, during a dinner with the tippee (who was the tipper's financial adviser and who had discretionary authority over the tipper and his wife's securities accounts),[394] said "it would be nice to be king for a day."[395] The defendant claimed that he said nothing more about the Pfizer/King discussions to the financial adviser.[396]

But the Second Circuit, based on the adviser's subsequent actions, found that "the jury was entitled to disbelieve that [the defendant] communicated nothing more."[397] After the dinner, the financial adviser called a friend to ask what he should do with inside information that "Pfizer's buying King

390. As the First Circuit put it in analyzing why the jury had sufficient evidence to conclude that the *defendant* owed a duty to his *wife*, he "was sophisticated enough to know that [her] disclosures violated *her* duty of confidentiality to *Apollo*. Further, [his wife] allowed Kanodia access to the confidential papers about the acquisition by allowing him to stay in her Waldorf suite, even though Kanodia's presence created a reportable confidentiality risk. *Consequently*, the jury could conclude that Kanodia knew that information about Apollo was not his to share." *Id.* at 506 (emphasis added).

391. William K.S. Wang & Marc I. Steinberg, Insider Trading § 5.2.3[C][1] & [2] (Oxford University Press, 3d ed. 2010).

392. 913 F.3d 73, 74–75, 81 (2d Cir. 2019). The defendant was a lawyer who represented King in a patent lawsuit and learned about the acquisition from another lawyer in his firm. *Id.* at 76.

393. *Id.* at 78 (citing and quoting United States v. Gansman, 657 F.3d 85, 92 (2d Cir. 2011)).

394. *Id.* at 75–76.

395. *Id.* at 76.

396. *Id.*

397. *Id.* at 79.

Pharmaceuticals."[398] Then the adviser bought 65,150 shares of King stock for different accounts that he managed, including his own personal accounts and the defendant's IRA.[399] After Pfizer announced the acquisition, the adviser sold the King stock he had purchased personally for an approximate $8,000 profit and sold the stock he had bought for clients (including the defendant) for a $328,038 profit.[400] The Second Circuit observed that "[c]ommon sense . . . would lead a rational juror to conclude" from this train of events that the defendant told his financial adviser more than simply "it would be nice to be king for a day."[401]

The Second Circuit then held that "a reasonable jury could infer that [the defendant] intended [his financial adviser] to trade" because "(1) [the adviser] was [the defendant's] money manager, with discretionary authority over [the defendant's] accounts," and the defendant made his remarks "during a meeting to discuss his investment portfolio; (2) after meeting with [the defendant], [the adviser] immediately bought hundreds of thousands of dollars of King stock, including in [the defendant's] account . . . ; and (3) [the adviser], on behalf of [the defendant], had previously purchased stock in one of [the defendant's] clients, Enzo [Pharmaceuticals]."[402]

Extraterritorial government enforcement of antifraud provisions. In *Morrison v. National Australia Bank Ltd.*, the Supreme Court held—in light of the presumption that a U.S. law does not operate outside the territorial boundaries of the country unless the law includes a clear statement that it should be extraterritorially applied—that Exchange Act section 10(b) and Rule 10b-5 reach "the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."[403] The Court denominated this conclusion as addressing "what conduct § 10(b) prohibits, which is a merits question," as opposed to "[s]ubject-matter jurisdiction, [that] by contrast, 'refers to a tribunal's power to hear a case.'"[404] Within a month of *Morrison*'s

398. *Id.* at 76–77.

399. *Id.* at 77. The financial adviser's friend purchased both King stock and call options on that stock. *Id.*

400. *Id.* The adviser's friend sold his King stock and options for a $110,000 profit. *Id.*

401. *Id.* at 79.

402. *Id.* The court also noted evidence that the defendant thought his adviser's stock purchases in 2009 and 2010 had been "'too bearish'" and that he wanted the adviser to make more aggressive buys to increase returns. *Id.* at 80.

Two other decisions addressed the special civil penalty statute applicable to insider trading. 15 U.S.C. § 78u-1 (2018). The Second Circuit held that (i) the base for the triple limit in that statute—three times the profits gained or losses avoided—includes gains and losses avoided in all the accounts for which a defendant made trades on the basis of the material nonpublic information and (ii) the trial court did not abuse its discretion by considering the defendant's wealth when imposing a $92.8 million penalty. SEC v. Rajaratnam, 918 F.3d 36 (2d Cir. 2019),The Seventh Circuit found no abuse of discretion in imposition of a nearly $1.6 million penalty, after the district court determined that the defendant's whistleblowing provided limited value to the government. SEC v. Williky, 942 F.3d 389 (7th Cir. 2019), *petition for cert. filed,* No. 19-997 (U.S. Feb. 6, 2020).

403. 561 U.S. 247, 255, 261–65, 273 (2010).

404. *Id.* at 254 (quoting Union Pac. R.R. Co. v. Locomotive Eng'rs, 558 U.S. 67, 81 (2009) (quoting Arbaugh v. Y & H Corp., 546 U.S. 500, 514 (2006), in turn quoting United States v. Cotton, 535 U.S. 625, 630 (2002))) (some internal quotation marks omitted).

publication but apparently without careful consideration of this distinction, the Dodd–Frank Wall Street Reform and Consumer Act ("Dodd–Frank") added to federal statutes provisions stating that U.S. district courts have "jurisdiction" over actions under Securities Act section 17(a) and any "violation of the anti-fraud provisions" of the Exchange Act (including section 10(b)) where (i) the U.S. government or the Commission files the case and (ii) either (a) "conduct within the United States . . . constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors" or (b) "conduct occurring outside the United States . . . has a foreseeable substantial effect within the United States,"[405] with (ii)(a) & (b) known as the "conduct-and-effects" test.[406]

The Tenth Circuit held in 2019 that "[n]otwithstanding the placement of the Dodd–Frank amendments in the jurisdictional provisions of the securities acts, given the context and historical background surrounding Congress's enactment of those amendments, it is clear to us that Congress undoubtedly intended that the substantive antifraud provisions should apply extraterritorially when the statutory conduct-and-effects test is satisfied."[407] By that jurisdictional change, "Congress has 'affirmatively and unmistakably' indicated that the antifraud provisions of the federal securities acts apply extraterritorially when the statutory conduct-and-effects test is met," therefore overriding the presumption against extraterritoriality when the government invokes sections 17(a) and Rule 10b-5 in its enforcement actions.[408]

In the case in which the Tenth Circuit rendered this holding, the defendant ran a Utah LLC from his apartment in that state.[409] The LLC operated through a website "on servers physically located in the United States."[410] Before buying from the LLC, customers had to become "members," a step they accomplished through that website.[411] The customers could then purchase advertising services, including clicks on their online advertisements or visits to their websites—e.g., buying twenty ad clicks for $5 and 1,000 visits to a website for $5.95.[412] They could also buy Adpacks for $50 each.[413] Each Adpack included the twenty clicks and the 1,000 visits *and* "the opportunity to share in [the LLC's] revenue up to a maximum amount of $55."[414] To qualify for that revenue participation on a given day, the customer had to click—that day—on a prescribed number of internet ads for other members (at first ten, then raised to fifty) and remain on each ad's website

405. SEC v. Scoville, 913 F.3d 1204, 1215, 1217 (10th Cir. 2019) (quoting 15 U.S.C. §§ 77v(c), 78aa(b)) (pointing out that the day the Court issued *Morrison* was the last day that a joint congressional committee considered Dodd–Frank), *cert. denied*, 140 S. Ct. 483 (2019) (mem.).

406. *Id.* at 1209. Even though the "conducts-and-effects" test joins the two words with "and," *either* the relevant conduct *or* the relevant effect suffices.

407. *Id.* at 1218.

408. *Id.*

409. *Id.* at 1209.

410. *Id.* at 1210.

411. *Id.*

412. *Id.*

413. *Id.*

414. *Id.*

landing page for a minimum of five seconds.[415] A member could purchase as many Adpacks as he or she wanted, and the clicks and landing page website visits on a given day counted toward the revenue-sharing threshold for all the Adpacks so that, "no matter how many Adpacks a member purchased, the member could qualify to share in [the LLC's] revenue on all of those Adpacks through a single four-minute session clicking on other members' ads."[416] The member could reach the maximum $55 revenue sharing/Adpack in about fifty-five days of such clicking—thereby reaping, from each Adpack, a profit of $5 (the $55 in revenue sharing minus the $50 cost of the Adpack).[417] While the Adpacks included the clicks on the purchasing members' ads and visits to their websites, the LLC "only delivered about 10 percent of the clicks and website visits it sold as part of the Adpacks," and the district court found that, for many members, the profit from the revenue sharing constituted the principal motivation for buying the Adpacks.[418] In addition to the revenue sharing, each member received a 10 percent commission on services (including Adpacks) bought by a new member whom the member recruited and who purchased services from the LLC.[419] Revenue from selling the Adpacks constituted more than 98 percent of the LLC's total sales.[420]

The SEC sued the LLC's sole member and manager, alleging that the Adpacks were securities and that the defendant was selling them through a Ponzi scheme, in violation of Securities Act section 17, Exchange Act section 10(b), and Rule 10b-5.[421] Affirming preliminary orders by which the district court froze assets, appointed a receiver, and prohibited further operation of the business,[422] the Tenth Circuit held that, notwithstanding that people living outside the United States bought 90 percent of the Adpacks,[423] the alleged fraud easily passed the conducts-and-effects test.[424] The defendant's creation and promotion of "the Adpack investments over the internet while residing in Utah" and use of servers "physically located in the United States" was "'conduct within the United States . . . constitut[ing] significant steps in furtherance of the violation' of Rule 10b-5 and Section 17(a)."[425]

415. *Id.*
416. *Id.* at 1210–11.
417. *Id.*
418. *Id.* at 1211.
419. *Id.*
420. *Id.*
421. *Id.* at 1209, 1212–13.
422. *Id.* at 1209, 1213, 1225.
423. *Id.* at 1211, 1214 (adding that "Adpacks were especially popular in poorer countries, including Bangladesh, Venezuela, and Morocco").
424. *Id.* at 1219.
425. *Id.* (quoting district court, in turn quoting 15 U.S.C. § 77v(c)).

The Tenth Circuit delivered one other holding of note: that the Adpacks were "investment contracts" within the meaning of the definition of securities in the Securities Act and the Exchange Act. *Id.* at 1220–22; *see also* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2018). There was no question that the LLC's customers who bought Adpacks each invested money. *Id.* at 1210. Moreover, while some "Adpack purchasers testified that they bought Adpacks for the advertising services," "the vast majority of $50 Adpack purchasers bought Adpacks, not to receive the same advertising services they could have bought ala carte for $10.95, but instead to have the opportunity to share in

Misstatements and omissions in proxy statements. When companies solicit proxies to vote securities registered under Exchange Act section 12, they must comply with the rules the SEC has promulgated to govern those solicitations.[426] Rule 14a-9 is one such rule, and it prohibits making in a solicitation "any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading."[427] The Fourth Circuit published two decisions last year in Rule 14a-9 cases. In the first, the court held that a proxy statement did not mislead by using year-old financial figures to estimate the value of stock used as payment in a merger, because the proxy statement expressly stated that it was using those old figures, advised clearly that the valuation had not been updated to account for subsequent events, and warned target company shareholders that the value of the acquiring company's stock they would ultimately receive on closing was uncertain.[428] In the second, the court reversed dismissal of a Rule 14a-9 claim, holding that a jury should decide the materiality of discussions, conducted before the shareholder vote, about the compensation that the target's top executive might receive at the surviving company.[429]

Year-old financial numbers used to value stock of acquiring company where such stock was part of the consideration for a merger. In 2019, the Fourth Circuit affirmed dismissal of an action alleging misstatements and omissions in a proxy solicitation addressed to shareholders of a target company who were voting on approval of a merger of their company, a real estate investment trust ("REIT") named American Realty Capital–Retail Centers of America, Inc. ("RCA"), with American Finance Trust, Inc. ("AFIN"), another REIT.[430] The consideration to the suing shareholders comprised 0.385 shares of AFIN common stock and $0.95 in cash per RCA share that, in aggregate, provided an estimated value of $10.26.[431] This amount depended therefore on the value of AFIN stock,

[the LLC's] revenue and earn significant returns." *Id.* at 1221. "The revenue in which Adpack purchasers could share, then, was generated from a common enterprise," the operation of the LLC. *Id.* And the draw of the revenue provided the reasonable expectation of profit from the efforts of others because, although the LLC conditioned revenue sharing on each customer clicking on other customers' banner ads and visiting other customers' websites, the "Adpack purchasers did not expect their own efforts to be significant [in producing the revenue they would share]. No matter how many Adpacks a member owned, the member expected to qualify to share revenue on all of his or her Adpacks by spending only four minutes a day clicking on up to fifty ads." *Id.* at 1222.

In a concurring opinion, one of the panel's judges concluded that the scheme met the *Morrison* test because the LLC "made its sales through computer servers based solely in the United States" and therefore, "[u]nder any common sense reading of *Morrison* and § 10(b), Traffic Monsoon made several securities sales in the United States." *Id.* at 1225–27 (Briscoe, J., concurring); *id.* at 1226 ("[The LLC] executed all the AdPack sales in an automated manner in the United States.").

426. 15 U.S.C. § 78n(a) (2018).

427. 17 C.F.R. § 240.14a-9(a) (2020).

428. *See infra* notes 430–40 and accompanying text.

429. *See infra* notes 441–47 and accompanying text.

430. Paradise Wire & Cable Defined Benefit Pension Plan v. Weil, 918 F.3d 312, 315 (4th Cir. 2019).

431. *Id.* at 316. The appellate opinion states neither that the consideration included a fixed amount of AFIN stock nor the amount of cash, but the district court opinion includes both these

and that, in turn, depended on AFIN's net asset value ("NAV").[432] The target distributed its proxy solicitation on December 16, 2016, for a shareholder vote that took place in February 2017.[433] The solicitation contained an AFIN NAV of $24.17 per AFIN share, calculated as of December 31, *2015*, and the $10.26/RCA share estimate of the total merger consideration rested on that valuation, which was almost a year old.[434]

The shareholders contended that the solicitations' "repeated references to AFIN's NAV as $24.17 were materially false or misleading [and therefore violated Rule 14a-9] because, by the time [the target distributed the solicitation], AFIN's NAV was no longer $24.17."[435] The Fourth Circuit rejected this argument because (i) the solicitation expressly identified $24.17 as the AFIN NAV as of December 15, 2015; (ii) the plaintiffs did not contend that number was incorrect as of that date; and (iii) the solicitation (a) "warned that AFIN's NAV of $24.17 did not reflect events after December 31, 2015, that would affect AFIN's NAV," (b) cautioned "that the exchange rate, which was based on the NAV, would not be updated," and (c) advised "that the [target] Shareholders could not be sure of the value of AFIN's common stock they would receive upon finalization of the merger."[436] These "extensive, specific, and tailored" "warnings" were sufficient to invoke the "'bespeaks caution' doctrine," that "claims are 'subject to dismissal if cautionary language in the offering document negates the materiality of the alleged misrepresentations or omissions'"—here "negat[ing] the materiality of the alleged statements and omissions concerning" the "outdated" $24.17 NAV.[437]

In one other holding of note, the court rejected the shareholder contention that the solicitation misled by including projections for AFIN's financial performance as a standalone company because those projections "omitted information that: (1) several of the areas of projected performance had declined in 2016 before the merger; (2) AFIN's rental income had grown only by 2 percent in 2016; and (3) AFIN's disappointing rental income growth resulted from the sale of the [certain] properties and [a decision by] SunTrust Bank" against renewing leases for forty-five branches.[438] The Fourth Circuit pointed to language in the solicitation stating that the standalone projections (i) "were only disclosed because they had been made available to various professionals in the merger negotiation process"; (ii) "'were based on numerous variables and assumptions that were deemed to be reasonable as of the respective dates when the projections were finalized'"; (iii) were "subject to change and [did] not reflect revised prospects for AFIN's business"; and (iv) were "'not being included in this [solicitation]

facts. Paradise Wire & Cable Defined Benefit Pension Plan v. Weil, Civil Action No. CCB-17-132, 2018 WL 1535496, at *1 (D. Md. Mar. 28, 2018).

432. *Paradise Wire*, 918 F.3d at 316.

433. *Id.*

434. *Id.*

435. *Id.* at 318.

436. *Id.* at 318–19.

437. *Id.* at 319–20.

438. *Id.* at 320–21.

to influence your vote.'"[439] Given this context, "the alleged improper omissions cannot plausibly be material."[440]

Pre-shareholder-vote discussions of compensation at surviving company for target's top executive. The Fourth Circuit vacated dismissal of a Rule 14a-9 claim by former shareholders of Towers Watson & Co. ("Towers"), who contended that the solicitation sent to them to vote in favor of Towers' merger with Willis Group Holdings plc ("Willis") to form a new company called Willis Towers Watson plc ("WTW") misled by stating that the Towers' board had considered all relevant conflicts of interest and by omitting facts that showed a further conflict.[441] The plaintiffs alleged that—unbeknownst to the Towers board—the Towers CEO (John Haley) had met with Jeffrey Ubben (who was the CEO of a major investor in Willis, who was involved in the merger negotiations, and who would be on the compensation committee of the combined company) and that, during the meeting, Ubben discussed with Haley a compensation package by which Haley might earn as much as $165 million over three years.[442] The plaintiffs further charged that, because of the incentive created by this possible compensation bonanza, Haley did not bargain hard on the Towers shareholders' behalf during the merger negotiations but instead sought only the minimum consideration that would motivate the shareholders to approve the deal.[443]

Holding that the district court erred in finding the omitted facts immaterial,[444] the Fourth Circuit found that those facts were not rendered unimportant by the shareholders' knowledge that "Haley would be CEO of WTW and that he was therefore operating under a potential conflict of interest."[445] The omitted information added more—that "Haley had entered secret discussions with Ubben, who was slated for a seat on WTW's Compensation Committee, for a more than six-fold increase in his current compensation" and therefore "had a powerful interest in closing the merger to get the compensation he'd discussed with Ubben, even if the terms were unfavorable for Towers shareholders."[446] As the case came to the court of appeals (insofar as this issue was concerned) on appeal of a dismissal for failure to state a cause of action, it was sufficient for materiality that "[a] jury could . . . reasonably conclude that disclosing the secret compensation discussions between Haley and Ubben would have changed the total mix of information available to shareholders."[447]

439. *Id.* at 321–22.

440. *Id.* at 323.

441. *In re* Willis Towers Watson plc Proxy Litig., 937 F.3d 297, 300, 301–02 (4th Cir. 2019).

442. *Id.* at 300–01.

443. *Id.* at 301. The court also held that the case could not be dismissed on statute of limitations grounds. *Id.* at 302–04.

444. *Id.* at 306.

445. *Id.* at 304.

446. *Id.* at 305.

447. *Id.* The panel divided two to one. The dissenter stressed that the "Complaint depend[ed] on an actual compensation agreement" but "fail[ed] to allege that Ubben had any authority to enter into an executive compensation agreement on behalf of WTW, an entity that had not been formed at the time Ubben met with Haley." *Id.* at 311 (Quattlebaum, J., dissenting). The majority responded that, even without a formal agreement, "[a] reasonable jury could nonetheless find that Ubben's influence

Sanctions in SEC enforcement and criminal actions. The Second and Fifth Circuits declined to hold that the Supreme Court's 2018 *Kokesh v. SEC* decision means that district courts have no jurisdiction to order disgorgement in SEC enforcement actions, and the Supreme Court granted certiorari in a Ninth Circuit case to resolve that issue.[448] The Third Circuit held that actions by the SEC for injunctions—if granted on the proper grounds—are not subject to the five-year statute of limitations applicable to penalties.[449] The Second Circuit affirmed a sentence enhancement based on an aggravating factor not included in the Sentencing Guidelines.[450]

***Kokesh* fallout**. The Supreme Court's 2018 *Kokesh* opinion held that disgorgement in SEC enforcement actions is a "penalty" within the meaning of the five-year statute of limitations applicable to an "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise."[451] Last year brought follow-on decisions.

Whether *Kokesh* means that district courts have no equitable jurisdiction to order disgorgement in SEC enforcement actions. In two cases, courts of appeals considered whether *Kokesh* implies that the district courts lack the power to order disgorgement in SEC enforcement actions at all. The defendant in a Second Circuit case challenged a disgorgement remedy on the theory that (i) "disgorgement has historically been rooted in equity," (ii) "equitable relief does not include penalties," (iii) *Kokesh* holds that disgorgement in SEC cases is a penalty, and therefore (iv) federal courts cannot impose disgorgement in SEC actions on the basis of their equitable jurisdiction.[452] Noting that (i) the Supreme Court specifically declined to address in *Kokesh* "whether courts possess authority to order disgorgement in SEC enforcement proceedings or . . . whether courts have properly applied disgorgement principles in this context," and (ii) the Second Circuit had not—by any en banc decision—determined that longstanding circuit precedent permitting disgorgement is no longer good law, the court of appeals concluded that "*Kokesh* does not constitute an intervening decision such that our precedent on disgorgement in SEC enforcement proceedings is disturbed."[453] The Fifth Circuit reached a similar conclusion on similar reasoning, declining to hold that "*Kokesh* quietly revolutionized SEC enforcement proceedings while at the same time explicitly stating it was not doing so," and finding that the panel was bound by previous circuit authority expressly recognizing

over Haley's compensation was enough to convince Haley to agree to unfavorable terms for shareholders in order to secure a lucrative compensation package for himself." *Id.* at 306.

For another proxy solicitation opinion, see *supra* notes 201–23 and accompanying text.

448. *See infra* notes 451–56 and accompanying text.

449. *See infra* notes 457–74 and accompanying text.

450. *See infra* notes 475–76 and accompanying text.

451. Kokesh v. SEC, 137 S. Ct. 1635, 1643 (2017); 28 U.S.C. § 2462 (2018) (quoted language).

452. SEC v. de Maison, 785 F. App'x 3, 6 (2d Cir. 2019), *petition for cert. & motion for leave to proceed in forma pauperis filed*, No. 19-7714 (U.S. Feb. 18, 2020).

453. *Id.*

the authority of district courts to enter disgorgement orders in SEC enforcement actions since "*Kokesh* did not unequivocally abrogate [that] circuit precedent."[454]

Significance and analysis. In a 2018 opinion, a Ninth Circuit panel also deferred to prior circuit authority holding that federal courts can require defendants in SEC enforcement actions to disgorge ill-gotten gains.[455] In November 2019, the Supreme Court granted certiorari in that case, and hopefully will resolve whether district courts in which the Commission files civil actions have authority to order disgorgement.[456]

Whether, under *Kokesh*, district court injunctions in SEC enforcement actions are, like disgorgement, subject to the five-year statute of limitations for penalties. In a lawsuit brought by the SEC eight years after the underlying events, the Commission sought two remedies: (i) an injunction to "[p]ermanently restrain[ ] and enjoin[the Defendant] . . . , his agents, servants, employees, attorneys and other persons in active concert or participation with him who receive actual notice by personal service or otherwise, from violating Sections 5(a), 5(c), 17(a), and 17(b) of the Securities Act, . . . and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b–5 thereunder . . ."; and (ii) an injunction "[p]ermanently prohibiting [the Defendant] . . . from participating in any offering of penny stock pursuant to Section 20(g) of the Securities Act, and Section 21(d)(6) of the Exchange Act."[457] After the district court dismissed the action as untimely, the Third Circuit vacated that order in a decision considering whether these injunctions were—like disgorgement—subject to the five-year statute of limitations for "penalties."[458]

Rejecting that position, the Third Circuit observed that "'[t]he historic injunctive process was designed to deter, not to punish.'"[459] Accordingly, "a properly issued and framed injunction" has, as its "'sole function . . . to forestall future violations'" and, "[i]n *Kokesh's* parlance, a preventive injunction [can] . . . 'fairly be said *solely* to serve a remedial purpose.'"[460] The court of appeals concluded that "this prevention principle most sharply distinguishes SEC injunctions from the disgorgement remedy at issue in *Kokesh*."[461]

To support this analysis, the Third Circuit reviewed the standards and actual operation of injunctions in SEC cases, emphasizing that the "analysis reinforces our conclusion [that such injunctions are not penalties] but also impels us to reinforce the parameters within which an SEC injunction is properly issued

454. SEC v. Team Res. Inc., 942 F.3d 272, 277 (5th Cir. 2019), *petition for cert. filed*, No. 19-978 (U.S. Feb. 3, 2020).

455. SEC v. Liu, 754 F. App'x 505, 509 (9th Cir. 2018).

456. Liu v. SEC, No. 18-1501, 2019 WL 5659111 (U.S. Nov. 1, 2019) (mem.).

457. SEC v. Gentile, Civil Action No.: 16-1619 (JLL), 2017 WL 6371301, at *3 (D.N.J. Dec. 13, 2017) [hereinafter *Gentile Dist. Ct.*] (some internal citations omitted).

458. SEC v. Gentile, 939 F.3d 549, 553–54, 552, 566 (3d Cir. 2019) (quoting 28 U.S.C. § 2462 at 552), *cert. denied*, 2020 WL 1906575 (U.S. Apr. 20, 2020) (No. 19-878) (mem.).

459. *Id.* at 556 (quoting Hecht Co. v. Bowles, 321 U.S. 321, 329 (1944)).

460. *Id.* (quoting first United States v. Or. State Med. Soc'y, 343 U.S. 326, 333 (1952), then quoting *Kokesh*, 137 S. Ct. at 1645 (internal quotations marks and citations omitted)).

461. *Id.*

and framed."[462] The court noted that "nothing in [the statutes authorizing the injunctive relief the SEC sought] suggests Congress meant to depart from the rule that injunctions are issued to prevent harm rather than to punish past wrongdoing."[463] Moreover, precedent required the SEC, in order to obtain an injunction, to "'establish a sufficient evidentiary predicate to show that [a] future violation may occur,'" with courts "mak[ing] that determination based on factors including not merely the fact of a past violation, but more importantly 'the degree of scienter involved [in the past violation], the isolated or recurrent nature of the infraction, the defendant's recognition of the wrongful nature of his conduct, [and] the sincerity of his assurances against future violations.'"[464] A court asked to impose an injunction should weigh the "stigma, humiliation, and loss of livelihood attend [ing]" an injunction, and refrain from issuing it without "a meaningful showing of necessity" to prevent future harm and, even then, should limit the harm the injunction does to the defendant by keeping the prohibition "as short and narrow as reasonably possible."[465] As a result of these standards, an injunction "may not be supported by the desire to punish the defendant or deter others," "courts abuse their discretion when they issue or broaden injunctions for those reasons," and an injunction that "cannot be supported by a meaningful showing of actual risk of harm . . . must be denied as a matter of equitable discretion—not held time barred by [the five-year statute of limitations applicable to penalties]."[466]

Turning from the legal standards for injunctions to the SEC's requests for them and their actual imposition by courts, the Third Circuit recognized the possibility that "the Commission more recently has tended to *seek* injunctions in part for their general deterrent effect," but, declining to "probe the agency's rationale," the court focused on the explanations courts have provided for granting prohibitory relief.[467] With that focus, the Third Circuit found "few signs that courts *issue* SEC injunctions for general deterrence."[468]

This left, however, the propriety of imposing the first of the two injunctions the SEC sought—a general injunction against violating a potpourri of securities statutes and rules, including the wide-ranging Rule 10b-5.[469] Such broad-ranging prohibitions are called "obey-the-law" injunctions.[470] While recognizing "some force" to the arguments "that obey-the-law injunctions pose a risk of overbreadth, lack of

462. *Id.* at 557.

463. *Id.* (citing 15 U.S.C. § 78u(d)(1), (6)(A)).

464. *Id.* (quoting first Aaron v. SEC, 446 U.S. 680, 701 (1980), then quoting SEC v. Bonastia, 614 F.2d 908, 912 (3d Cir. 1980) (alteration by the court)). The facts in this case provided considerable support for the conclusion that the defendant would violate the securities laws again in the future. He operated a Bahamas-based brokerage, had said that he planned to expand his business, denied on social media that he had committed any violations, and called the government's pursuit of him a "witch hunt." *Id.* at 553.

465. *Id.* at 559.

466. *Id.* at 562.

467. *Id.* at 563–64 (emphasis added).

468. *Id.* at 563 (emphasis added).

469. *See supra* note 457 and accompanying text.

470. *Id.* at 554 ("[15 U.S.C. §] 78u(d)(1) injunctions that simply reference or restate the text of statutory prohibitions are called 'obey-the-law' injunctions.").

fair notice, unmanageability, and noncompliance with Federal Rule of Civil Procedure 65(d)" and acknowledging that "in some cases—and perhaps in this one—an obey-the-law injunction will add little if anything to the sanctions already in place," the Third Circuit sidestepped these points on the basis that the defendant attacked the relief here solely on the basis that the injunctions were penalties barred by the five-year statute of limitations and not on these other grounds.[471] But the appellate court did counsel the district court on remand that it "should not rubber-stamp the Commission's request for an obey-the-law injunction simply because it has been historically permitted to do so by various courts" and "must" "reject" the SEC's request for this relief if the lower court, "after weighing the facts and circumstances of this case as alleged or otherwise, concludes that the obey-the-law injunction sought here serves no preventive purpose, or is not carefully tailored to enjoin only that conduct necessary to prevent a future harm."[472]

Significance and analysis. The bulk of the Third Circuit's opinion consists of restating the criteria for granting injunctions in cases brought by the SEC, emphasizing that they must be prophylactic rather than punitive and designed for specific rather than general deterrence. This strongly suggests—particularly in light of the court's reference to the SEC's enforcement "zeal"[473]—a concern that well-publicized broad injunctions are more a part of an overall deterrence campaign by the Commission rather than a strategy to prevent particular defendants from harming the public by further wrongdoing while targeting the prohibitions to avoid unnecessary damage to those defendants going forward.

Perhaps the least targeted relief the SEC regularly requests are obey-the-law injunctions. As the Third Circuit noted, criticism has hounded those sweeping prohibitions for years.[474] Whether the Third Circuit's self-styled effort to "reinforce the parameters within which an SEC injunction is properly issued and framed"—which went far beyond what was needed to decide the case before it—will incline courts to more narrowly fashion injunctive relief in SEC actions will bear watching.

Imprisonment. Affirming a sentence including thirty months of incarceration, the Second Circuit found no substantive unreasonableness in this punishment even though the trial court—"[b]ecause the Government failed to prove a loss amount" and accordingly failed to identify any "victims as defined in [Sentencing Guideline] 2B1.1(b)(2)(A)(i)"—added a "two-level, six-month upward departure" on the judge's conclusion that "the fraud victimized far more than 10 investors."[475] While the Sentencing Guidelines themselves did not include such an enhancement, they permit a "district court [to] depart from the Guideline range if there exists an aggravating or mitigating circumstance 'of a kind, or to a degree, not adequately taken into consideration by the Sentencing Commission.'"[476]

471. *Id.* at 564.
472. *Id.* at 565.
473. *Id.* at 563.
474. *See* the excoriating footnote in SEC v. Smyth, 420 F.3d 1225, 1233 n.14 (11th Cir. 2005).
475. United States v. Lawrence, 767 F. App'x 77, 83 (2d Cir. 2019).
476. *Id.* (quoting U.S.S.G. § 5K2.0(a)(1)(A)).

Definition of a security. Both the Securities Act and the Exchange Act include "investment contract" within the definition of "security."[477] The Supreme Court held in *SEC v. W. J. Howey Co*. that an "investment contract" "means a contract, transaction or scheme whereby a person [(1)] invests . . . money [(2)] in a common enterprise and [(3)] is led to expect profits [(4)] solely from the efforts of the promoter or a third party."[478] In 2019, the Fifth Circuit held that genuine issues of fact respecting the fourth element of this test precluded summary judgment in favor of the SEC that interests in oil and gas joint ventures were investment contracts.[479] In an odd case where the plaintiffs alleged that the defendants had purchased securities, that same court found sufficient allegations that interests in limited partnerships—formed as part of a complicated structure to provide and bill for a medical service—were investment contracts.[480] The Ninth Circuit affirmed summary judgment for the Commission in an action in which the SEC claimed that interests in limited partnerships formed to participate in the EB-5 investment program were securities, despite the defense argument that the investors were not led to expect profits but put their money into the partnerships in order to gain permanent residency status.[481]

Interests in oil and gas joint ventures. In *SEC v. Arcturus Corp*., the Fifth Circuit reversed summary judgment for the Commission on the ground that the evidence presented a genuine issue of fact as to whether profits derived from oil and gas interests were "solely from the efforts" of the defendants.[482] The court noted that post-*Howey* decisions have interpreted "solely"—in the fourth element of the *Howey* test—"'in a flexible manner'" rather than literally.[483]

The investors purchased interests in six different projects, each organized through a "joint venture agreement" ("JVA").[484] The appellate court employed the same analysis here that it uses when considering whether interests in partnerships are "investment contracts"—an analysis that begins with the presumption that interests in general partnerships are not investment contracts because of the extensive management authority that each partner in such an entity holds, but recognizes that interests in limited partnerships may be investment contracts because of the more limited management authority that each limited partner possesses.[485] But the presumption is rebuttable because "[l]abeling a partnership as general or limited does not always reflect what really matters . . .

477. 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2018).

478. 328 U.S. 293, 298–99 (1946). I have interlineated the numbers to identify the various elements of an "investment contract." Some decisions combine the last two and therefore analyze the definition as having three elements instead of four.

479. *See infra* notes 482–519 and accompanying text.

480. *See infra* notes 520–50 and accompanying text.

481. *See infra* notes 551–76 and accompanying text. For another decision considering whether an arrangement constituted an "investment contract," see *supra* note 425.

482. 928 F.3d 400, 404, 408, 424 (5th Cir. 2019).

483. *Id*. at 409 (quoting Youmans v. Simon, 791 F.2d 341, 345 (5th Cir. 1986)).

484. *Id*. at 404, 406.

485. *Id*. at 410.

[, which is] the division of power among the partners."[486] To structure this rebuttal, the Fifth Circuit relies on its *Williamson v. Tucker* three-factor test to determine whether a general partnership—or here a joint venture—allocates power so that its profits are produced by others, rather than the investors.[487] If any of the three *Williamson* factors are present, then that fourth *Howey* element is proved.[488]

The first factor is whether the enterprise's "agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership."[489] Here, each JVA gave the managers "'full and plenary power'" "to, among other things, (1) retain operators to drill and complete wells, (2) conduct surveys, (3) execute 'any and all contracts and agreements,' (4) make 'all' elections or decisions and 'bind the Joint Venture,' (5) make payments with funds belonging to the projects, (6) execute operating agreements, and (7) execute powers of attorney."[490] In addition, the managers could charge each JV "'all reasonable expenses'" they incurred, and the JVAs provided that "no investor besides the Manager could 'act on behalf of, sign or bind the Joint Venture with respect to Operations of the Joint Venture.'"[491] But the investors had the power to remove the managers by a 60 percent vote, and the JVAs made each of the enumerated seven powers "subject to 'the affirmative Vote of the Venturers.'"[492] Moreover, the record showed that the investors "utilized their powers," with "votes taken on a variety of actions, such as increasing production units; completion; workover and recompletion; new projects; and dissolution."[493]

The SEC, however, saw the investor voting power as illusory, for two reasons. First, the JVAs provided that, after making an initial investment to finance a prospect well, the investors would then vote on the manager's recommendation (based on the results of the prospect work) to complete the well (i.e., equip the well with the additional equipment to perform extraction) or not, with an additional assessment due for all investors if the vote was affirmative and with any investor who declined to pay the additional assessment losing his or her right to any revenue from the project.[494] Such a non-participating investor could return to participating investor status, but only by paying a substantial penalty.[495] The SEC argued that these contractual arrangements "present[ed] investors with a Hobson's choice"—voting as the manager recommended or losing their

486. *Id.*
487. *Id.*
488. *Id.*
489. *Id.* at 410–11 (quoting Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981)).
490. *Id.* at 412.
491. *Id.*
492. *Id.* at 412–13.
493. *Id.* at 413.
494. *Id.* at 408. If, after completing the well, the manager recommended additional operations—such as drilling deeper or fracking—another investor vote followed, with an additional assessment if the vote was affirmative. *Id.*
495. *Id.* at 414.

investment.[496] But the Fifth Circuit observed that the arrangement simply (i) gave those investors who disagreed with further work on a project a "chance to cut their losses" and (ii) from the viewpoint of the investors who wanted to go forward with the well, "prevent[ed] free-riding" by those who declined to pay for additional work.[497]

The SEC argued that the investors' voting power was meaningless for the second reason that, in each project, the manager controlled the information the investors received.[498] But the managers "sent email updates to the investors on numerous occasions," dispatched an email suggesting that investors might watch drilling operations via a video camera on site, and distributed multiple emails welcoming investors to visit drill sites; and fifteen investors (out of more than 340) provided "affidavits, declaring that they stayed well-informed through 'persistent status updates' in the form of 'geologic data, well data, proposed oil and gas contracts, . . . video surveillance and other forms of live monitoring.'"[499]

The SEC further contended that the investors, even if adequately informed, could not effectively exercise their voting power because they could not coordinate with one another.[500] While the SEC presented evidence that one investor had been threatened by a manager with legal action for communicating with other investors, the defendants (i) "show[ed] that the investors did in fact communicate with each other" through phone calls, emails, and at JV meetings and (ii) submitted documents in which the managers identified investors to each other.[501] Although each JV included between 35 to 108 investors, previous authority had found that even a venture with 160 participants was not so large as to dilute investor control to the point that they expected profits solely from the efforts of others within the meaning of the *Howey* test.[502]

Putting it all together, there was record evidence "that (1) the investors had formal powers, (2) they used these powers, (3) the voting structure was not necessarily coercive, (4) the investors received information, (5) they communicated with each other, and (6) the number of investors was not so high that [coordination problems] eliminated all of their power."[503] The Fifth Circuit therefore reversed the trial court ruling that the SEC had established the first factor in the *Williamson* test beyond a genuine issue of material fact.[504]

Williamson's second factor—which if present will, by itself, show that the investors expected profits from the efforts of others—is that the investors are "'so inexperienced and unknowledgeable in business affairs' that they [are] 'incapable of intelligently exercising' their powers."[505] Here, the Fifth Circuit took into ac-

496. *Id.*
497. *Id.* at 414–15.
498. *Id.* at 415.
499. *Id.* at 406 (discussing the total number of investors); *id.* at 415–16.
500. *Id.* at 416.
501. *Id.* at 416–17.
502. *Id.* at 417.
503. *Id.*
504. *Id.*
505. *Id.* (quoting Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981)).

count that the managers conducted a nationwide cold call solicitation to find prospects, but also noted that the ability of investors to use their powers did not depend on their having any "specialized background."[506]

The summary judgment record provided information on the qualifications of only twenty-five investors, "leaving nearly 315 unaccounted for,"[507] and the SEC relied on the statements of only four to prove investor inexperience.[508] "[M]any" of the twenty-five, however "did, in fact, have experience in oil and gas drilling" and "various investors had advisors helping them make decisions."[509] Moreover, the SEC focused on one investor who claimed he had "'no means to verify'" the manager's determination that a well should be completed.[510] But that investor had emailed the manager, saying "that (1) he understood a fair amount of the underlying 'geology' of different wells and felt capable of 'comparing' reports from 'each geologist'; (2) he was comfortable analyzing the 'engineering' across wells; (3) he knew many drilling acronyms and terms; and (4) he knew how to analyze production zones and past production history."[511] As to the cold calling to find prospects, the list that the promoters used "was not meant to include inexperienced offerees," might (according to at least some evidence) have included only accredited investors, and included the promoters' current clients who, by definition, had prior experience in such ventures.[512] All this meant that the record raised a genuine issue of fact "about the offerees' and investors' knowledge and experience," rendering the district court's summary judgment to the SEC on the second *Williamson* factor inappropriate.[513]

The third factor, which if present would show that profits were dependent on the efforts of others within the meaning of the investment contract test, is that "the investors are so 'dependent on some unique entrepreneurial or managerial ability of [the Managers] that [they] cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.'"[514] The SEC presented two arguments to establish this factor. First, the Commission claimed that since the managers of the JVs had contracted with the subcontractors performing the work at the project sites, the investors could not enforce those

506. *Id.* at 405, 417–18.

507. *Id.* at 407.

508. *Id.* at 418.

509. *Id.* at 419 (stating that "one investor declared that he had 'an engineering background' and 'participated in other energy ventures . . .'"; "another investor disclosed that he had 'done 83 of these projects over the last ten years'"; "[a]nother investor declared that he ha[d] 'extensive experience in investing in domestic energy and often defer[red] to the advice of [his] energy advisors and petroleum engineers'"; and the record showing that "[s]till others had general business experience" and that "many investors 'had their CPAs or attorneys call' the Defendants before investing").

510. *Id.* at 420.

511. *Id.*

512. *Id.* at 421. An "accredited investor" is one who satisfies the definition set out in Rule 501(a), 17 C.F.R. § 230.501(a) (2020), a definition that "attempts to identify those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary," U.S. Sec. & Exch. Comm'n, Report on the Review of the Definition of "Accredited Investor" 5 (2015).

513. *Arcturus Corp.*, 928 F.3d at 421–22.

514. *Id.* at 422 (quoting Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981)).

subcontracts if they voted the managers out.[515] The court did not agree that the SEC had proven this to be true, and concluded that the Commission "merely assumes that the right to enforce the contracts with drilling subcontractors sits solely with the Managers."[516] Second, the SEC argued that the investors would never replace the managers because the managers had complete control, per the JVAs, over the money that the investors put into the projects.[517] The Fifth Circuit disagreed because the JVs were structured as "segmented" operations, with the investors putting in up front only the money for the prospect work, with any further capital assessments dependent on investor votes.[518] Accordingly, while their initial investment was at the mercy of the managers, the investors "plausibly were able to cut [the managers] out of any completion contracts or subsequent operations."[519] Thus, there remained a genuine issue as to the third factor too, with the Fifth Circuit reversing the trial court ruling in favor of the SEC on that one as well.

Significance and analysis. *Arcturus* demonstrates the difficulty of SEC enforcement against promoters who employ a vehicle falling within the "investment contract" definition, when the vehicle raises money from a large number of investors. If the defendants put up a fight with affidavits from multiple investors showing that they have the sophistication to exercise substantial legal power given to them by organizing documents and that the investors have used that power—a court may be unwilling to grant summary judgment to the SEC on the threshold issue of whether the vehicle is a security at all.

Interests in limited partnerships formed as part of a structure for delivery of, and billing for, a specialized medical service. A second investment contract opinion, *Masel v. Villarreal*, featured the odd circumstance that the *plaintiffs* organized businesses and sold passive interests to the *defendants*, claiming that they only did so because the defendants gulled them into an elaborate enterprise through fraudulent statements.[520]

The business structure provided interoperative neuromonitoring ("IOM") services during surgery.[521] IOM services included a technical component performed by an operator of IOM machinery and a professional component performed by a licensed doctor.[522]

Plaintiff Masel and his business partner, Chandiramani, founded a family of entities to provide such services.[523] They did so after defendant Villarreal made a

515. *Id.*
516. *Id.* at 423.
517. *Id.* at 424.
518. *Id.*
519. *Id.*
520. 924 F.3d 734, 744 (5th Cir. 2019) ("[P]laintiffs attempt to argue that defendants' interests in the Neuron Shield entities were securities and that the agreement conveying those interests to defendants was a sale of securities (in relation to which defendants made fraudulent representations). In this scenario, somewhat idiosyncratically, plaintiffs are the promoters, and defendants are the investors.").
521. *Id.* at 739 (with the court explaining that IOM "is a method of monitoring a patient's nervous system during surgery").
522. *Id.*
523. *Id.* at 740.

number of representations, including that (i) she had "developed a 'secret sauce' while working at . . . insurance companies that allowed her to 'pinpoint how much any given [IOM] claim will pay within a 10 to 20 percent margin of error'"; (ii) "she could generate '$50,000 or more for each out-of-network IOM claim,' . . . 'could generate $20,000 in additional revenue for the technical component of monitoring, . . . typically got much more, [and] up to $50,000 for the professional component'"; (iii) "'the reimbursement cycle for out-of-network claims [was] around six months'"; and (iv) she "always" answered the question of what accounts receivable percentage her billing company collected by "'say [ing] 50% but a lot of times it[']s more.'"[524]

Alleging that they relied on these representations, Masel and Chandiramani organized Neuron Shield, LLC ("NS"), which contracted with CGR Investments, LLC ("CGR")—a company that Villareal owned—for management services in exchange for a 35 percent non-voting net-profits interest in NS.[525] NS also contracted with MPS—another company that Villareal owned—to provide billing services.[526] Then, Masel and Chandiramani organized a series of limited partnerships (each one carrying the name "Neuron Shield" followed by a number), with an accompanying, numbered Neuron Shield LLC as a general partner.[527] CGR purchased a 35 percent B interest in each of the Neuron Shield limited partnerships, under limited partnership agreements providing that the general partner could not "mak[e] certain enumerated major decisions (such as receiving a capital contribution or dissolving the partnership) without obtaining approval of each partner with an interest equal to or greater than 20 percent of the partnership, which would include CGR as a 35% interest-holder."[528] Both the agreement for the CGR profits interest in the Neuron LLC and the limited partnership agreements "'acknowledged the applicability of the Securities Act of 1933.'"[529]

Though this complicated, multi-entity business billed $190 million for IOM services, "MPS collected just $11 million," collecting nothing at all on half the claims it submitted.[530] Moreover, the billing cycle took from twelve to eighteen months, rather than the six months Villareal represented.[531]

Reasoning that a private section 10(b) plaintiff must plead, among other things, "'a connection between the misrepresentation . . . and the purchase or sale of a security,'" the Fifth Circuit "address[ed] the threshold question—not considered by the district court—whether plaintiffs . . . successfully pleaded the existence of a security."[532] In particular, the court analyzed whether the limited partnership interests that CGR acquired satisfied the *Howey* definition of an "investment contract," with the deciding factor being

524. *Id.* at 747.
525. *Id.* at 740.
526. *Id.* at 739, 740.
527. *Id.* at 740 & n.3.
528. *Id.* at 740–41, 746.
529. *Id.* at 740–41 (quoting plaintiffs).
530. *Id.* at 741.
531. *Id.*
532. *Id.* at 743.

whether the "*defendants* were passive investors" expecting profits from the efforts of others.[533] While acknowledging that the defendants had "significant day-to-day responsibilities," the court found that these did not derive from the limited partnership interests but from "what was essentially a service agreement subservient to the plaintiffs' formal powers under the limited-partnership agreements."[534] Although the defendants, in their capacity as limited partners, "had the power to block certain enumerated business decisions, including receiving capital contributions, admitting a new partner, and dissolving the partnership," the Fifth Circuit declined to "expand the law to say that such veto powers, standing alone, suffice to negate the existence of an investment contract when it comes to limited partnership interests."[535] Accordingly, since the defendants had no "formal power" to control the limited partnerships, they failed to "overcome the presumption that limited partnership[interests] are securities."[536]

Moving then to whether the complaint alleged fraud, the Fifth Circuit found that the defendants adequately pled that all four of the representations set out above were knowingly false.[537] The alleged fact that "MPS was ultimately unable to collect on the overwhelming majority of claims it billed" sufficed to plead falsity of Villarreal's claim to have developed a "secret sauce" that permitted her to estimate what a claim would pay within a margin of error of 10 percent to 20 percent.[538] The alternative inferences from the contrast between the representation and actual performance were "either (1) Villarreal had no algorithm and therefore misrepresented her capabilities when she pitched her investment to Masel, or (2) Villarreal had an algorithm and some intervening event prevented her algorithm from functioning as described."[539] Since "no intervening event" was alleged, the "more plausible" of the two inferences was that Villarreal had no algorithm at all.[540] It followed that the plaintiffs adequately alleged that Villarreal "was aware of this fact."[541]

533. *Id.* at 743–46; *id.* at 744 (quotation).

534. *Id.* at 746. This passage implies that CRG had a management contract with each of the limited partnerships, but the opinion does not state that expressly. The brief for the plaintiffs referred to "a series of Management Services, Profits Interest, and Limited Partnership Agreements" and stated that "[u]nder these agreements, CGR . . . functioned as the sole and exclusive manager to provide management, administrative and other related services to the particular Neuron Shield entities with which [CGR and another Villarreal entity] were associated." Brief for Appellants, 2018 WL 4050370, at *12 (Aug. 16, 2018).

535. *Masel*, 924 F.3d at 746.

536. *Id.*; *see also* text accompanying *supra* note 485.

537. *Masel*, 924 F.3d at 747–52. The appellate court affirmed the trial court's determination that the complaint failed to adequately plead three other misrepresentations and three omissions. *Id.* at 748–49. In addition, while the plaintiffs sued two defendants, the Fifth Circuit affirmed the trial court's dismissal of the entire Rule 10b-5 claim against one of the defendants—even of the portion of the Rule 10b-5 claim resting on the properly pled misrepresentations—because "nothing in the complaint suggests that *he* had any basis to know that they were false." *Id.* at 752 (emphasis added).

538. *Id.* at 750, with the court elaborating: "Where . . . the representation in question concerned an asset or skill possessed by the defendant (here, an algorithm), the defendant's failure to perform as promised casts doubt on whether he possessed that skill in the first place." *Id.*

539. *Id.*

540. *Id.*

541. *Id.* at 752.

Since Villarreal admitted in another proceeding that the billing cycle was in fact twelve to eighteen months, her representation that the cycle lasted only six months was false and "this too was purportedly based on information gleaned from her [own] work," which justified the inference that she knew the cycle was longer when she made the representation.[542] While the district court had ruled that the other two representations—(i) that she could generate $50,000 for each out-of-network IOM claim, $20,000 in additional revenue from the technical component of claims, and $50,000 for the professional component and (ii) that the accounts receivable handled by MPS collected 50 percent or a lot more on the dollar—were "nonactionable . . . predictions," the Fifth Circuit saw them as "relat[ing] to the present capabilities of the MPS algorithm."[543] The "failure of Villarreal to come close to generating the profits represented casts doubt on the veracity of her statements as to the algorithm's existence" and certainly therefore on "her statements as to how well the supposed algorithm could perform."[544] It was "plausible" therefore "that Villarreal knew her algorithm could not generate the expected returns because her representations on this subject were based on metrics and information within her own control."[545] With the complaint alleging fraud and a security, the court of appeals reversed the district court's grant of a motion to dismiss, insofar as it extended to the four properly pled misrepresentations.[546]

Significance and analysis. *Masel* presents the extremely unusual case in which the plaintiffs organized the business and sold investment contracts to the defendants. The complaint alleges in the Rule 10b-5 count that "[b]ut for the[] misrepresentations, Plaintiffs would not have sold the interests, *or invested the moneys that amounted to millions [to generate IOM] claims that would never be paid*."[547] It thus appears that the plaintiffs sought to recover the money that they put into the entire business enterprise—all the different entities—on the theory that they would never have organized any of them had the defendants not euchred them into it. The Fifth Circuit does not address whether all those damages suffered were "in connection with" the sale of the limited partnership interests or whether those damages were recoverable under Rule 10b-5 damages law.

The court's conclusion that the plaintiffs pled scienter with respect to the representations repeatedly uses the term "plausible."[548] The Exchange Act, however, requires that a private plaintiff seeking damages under Rule 10b-5 plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[549] The Supreme Court has interpreted this standard as demanding that "an inference of scienter must be

542. *Id*. at 750, 752.
543. *Id*. at 750–51.
544. *Id*. at 751.
545. *Id*. at 752.
546. *Id*. at 742, 752.
547. First Amended Complaint at para. 193, Masel v. Villareal, No. 4:17-cv-00533, 2018 WL 1858149 (E.D. Tex. Oct. 20, 2017), 2017 WL 10059182 (emphasis added).
548. *Masel*, 924 F.3d at 752.
549. 15 U.S.C. § 78u-4(b)(2)(A) (2018); *see supra* notes 131–35 and accompanying text.

more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[550] In *Masel*, misuse of the term "plausible" in the court's scienter analysis probably worked no harm because the extreme contrast between actual collections and the purported capabilities of the defendants' collection algorithm may have indeed supported a strong inference that the defendant never possessed the collection capabilities she touted. Still, the court's suggestion that plausibility suffices may lead district courts into error.

Interests in limited partnerships formed to make EB-5-qualifying investments. Attorney Hui Feng represented foreign nationals seeking to participate in the EB-5 program.[551] EB-5 offered permanent residency to any immigrant who made a direct investment of $1 million or more in a new business that created ten or more full-time jobs for U.S. workers, or $500,000 in such a business located in a "targeted employment area."[552] Immigrants could aggregate their funds and make pooled investments in projects offered by regional centers regulated by the U.S. Citizenship and Immigration Services.[553] The regional centers created limited partnerships for the pooled investments, with the investing immigrants as limited partners and the regional centers as the general partners.[554] The limited partnerships used the money that the immigrants invested to fund construction projects.[555] Many PPMs for the limited partnerships "referred to the investments as 'securities' and asserted that the investments were compliant with U.S. securities laws."[556] The PPMs also promised investors a fixed return of from 0.5 percent to 5 percent, and (subject to market risk) return of their investments at the conclusion of a fixed term, usually five to six years.[557]

Clients paid Feng a $10,000 to $15,000 initial fee.[558] Feng also received a commission from regional centers for each of Feng's clients who invested in a limited partnership.[559] Since many regional centers refused to pay commissions to U.S. attorneys not registered as brokers, Feng—who never registered as a broker—used relatives as overseas "recruiters," to whom the regional centers paid the commissions, with those relatives then forwarding the commissions to Feng.[560] Feng also set up a Hong Kong company (Atlantic Business Consulting Limited or "ABCL"), of which he was the beneficial owner and his mother the nominal president, and facilitated agreements between that company and regional centers by which the centers paid commissions to ABCL even though—

550. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).
551. SEC v. Feng, 935 F.3d 721, 725–26 (9th Cir. 2019).
552. *Id.* at 725–26.
553. *Id.* at 726.
554. *Id.* at 727.
555. *Id.*
556. *Id.*
557. *Id.*
558. *Id.* at 726.
559. *Id.* at 726–27.
560. *Id.* at 727.

unbeknownst to the centers—Feng himself solicited and referred investors to ABCL and controlled ABCL's bank account.[561]

The regional centers charged immigrant investors an administrative fee of from $30,000 to $50,000, over and above capital contributions.[562] Centers were willing to reduce the administrative fee, taking the reduction out of any commission they were paying.[563]

Feng did not disclose to his clients (i) the commissions he received from the regional centers, unless clients "specifically asked about them"[564] and (ii) that, as he negotiated for rebates of administrative fees, he was conflicted because any reduction in those fees came out of his commissions.[565]

When the SEC sued Feng for fraud in selling securities and failure to register as a broker-dealer, Feng moved for summary judgment on the ground "that the EB-5 investments were not 'securities.'"[566] After denying his motion, the district court granted the SEC's motion for summary judgment in the case overall, and the Ninth Circuit affirmed.[567]

Analyzing whether Feng's clients put their money into "securities," the Ninth Circuit considered whether they had purchased "investment contracts."[568] Since it was "undisputed that Feng's clients invested money in a common enterprise managed by a third party," the only element of an investment contract in dispute was whether the clients had been "led to expect profits."[569] The circumstance that the PPMs offered fixed annual returns of 0.5 percent to 5 percent presented no issue because "[t]he Supreme Court has reasoned that the promise of a fixed rate of return should be viewed as triggering an expectation of profits."[570] While Feng argued that, when the administrative fee was considered together with the promised return, "the investor could not have expected to make any profit," the Ninth Circuit observed that the administrative fee was separate from the investment both by express identification of the two different amounts but also by the EB-5 requirement that investment must be "'at risk for the purpose of generating a return on the capital placed at risk.'"[571] In response to Feng's further argument that the immigrants were motivated not by an expectation of profit but by the lure of permanent residency, the court of appeals responded that "[a]n EB-5 investor's interest in a visa is inextricably tied to the financial success of the regional center's project" because only a profitable project would "likely to be sustained

561. *Id.* at 727, 736.
562. *Id.* at 727.
563. *Id.* at 728.
564. *Id.* at 726.
565. *Id.* at 728.
566. *Id.*
567. *Id.* at 728, 737.
568. *Id.* at 729.
569. *Id.*; and see quotation from *Howey* in text at *supra* note 478.
570. *Id.* at 729–30 (citing SEC v. Edwards, 540 U.S. 389, 396 (2004)).
571. *Id.* at 730 (quoting 8 C.F.R. § 204.6(j)(2)).

long enough to create the requisite jobs to qualify the investor for the EB-5 visa."[572]

Having thereby dispatched the overarching question of whether the SEC had brought a securities case, the Ninth Circuit rejected Feng's arguments on the merits. To Feng's argument that he was not a broker who needed to register, the court of appeals responded that "[h]e received commissions from regional centers, sought investors and clients through his website and other online forums, negotiated with regional centers about the terms of the projects, and gave advice about EB-5 projects' likelihood of success," which showed "that much of the work Feng performed for his clients, rather than being traditional legal work, aligns with the indicia of broker activity."[573] Turning to the fraud counts, the Ninth Circuit concluded that Feng—who operated both as a broker and as an immigration attorney—had a duty imposed by legal ethics to disclose conflicts of interests to his clients[574] and that he violated that duty by failing to disclose that (i) he received commissions from regional centers for his clients' investments and (ii) when he negotiated with a regional center on behalf of clients for rebates of their administrative fees, such rebates effectively cut into his commissions.[575] He also defrauded the regional centers that refused to pay commissions to U.S. attorneys not registered as brokers when he arranged for such commissions to be funneled to him by family members living overseas and through ABCL.[576]

SLUSA. SLUSA precludes "(1) a covered class action (2) based on state law claims (3) alleging that the defendants made a misrepresentation or omission or employed any manipulative or deceptive device (4) in connection with the purchase or sale of (5) a covered security,"[577] which is a security traded on a national exchange or a security issued by a registered investment company.[578] Last year, the Ninth Circuit held that SLUSA did not preclude a state law claim by the beneficiary of a trust where the challenged securities purchases

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572. *Id.* at 731. The Ninth Circuit also observed that (i) "[i]nvestments in limited partnerships generally constitute investment contracts," and (ii) "[t]he PPMs repeatedly referred to the investments as 'securities' and explained that the offerings were made pursuant to U.S. securities laws. Although 'the name given to an instrument is not dispositive,' 'most instruments bearing th[e] traditional titles [associated with securities] are likely to be covered by the statutes.'" *Id.* at 729 (alteration by the court) (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 850 (1975)).

573. *Id.* at 732.

574. *Id.* at 735 (relying on New York Rules of Professional Conduct).

575. *Id.* at 735–37.

576. *Id.* at 736–37. For another decision involving the EB-5 program, see *supra* notes 85–99 and accompanying text.

577. Northstar Fin. Advisors, Inc. v. Schwab Invs., 904 F.3d 821, 828 (9th Cir. 2018).

578. SLUSA appears at 15 U.S.C. §§ 77p, 78bb(f). SLUSA defines a "covered security," with an exclusion not relevant here, by cross-referencing Securities Act sections 18(b)(1) & (2) [15 U.S.C. § 77r(b)(1) & (2)], with section 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"; and section 18(b)(2) reading: "a security issued by an investment company that is registered, or that has filed a registration statement, under the Investment Company Act." 15 U.S.C. §§ 77p(f)(3), 78(f)(5)(E) (2018).

were not directed by that beneficiary but by a trustee who allegedly chose to invest trust money in securities purchases that benefited a trustee affiliate.[579] In a case of first impression, the Seventh Circuit held that a class action asserting state law claims based on misrepresentations or omissions in the purchase or sale of securities fell within one of the alternative definitions of a "covered class action" and was therefore precluded by SLUSA even though the class numbered fewer than fifty-one members.[580] The Third Circuit held that state law claims asserted in cases brought by sixteen plaintiffs who opted out of federal securities class actions were not within the definition of a "covered class action" and therefore were not SLUSA-precluded where the opt-outs filed their actions after the related federal securities class actions concluded.[581]

The "in connection with" criterion. In a 2014 opinion, the Supreme Court held that, to satisfy the criterion that a SLUSA-precluded action involve fraud "in connection with" the purchase or sale of a security, a misrepresentation or omission must be "material to a decision by one or more individuals (*other than the fraudster*) to buy or to sell a 'covered security.'"[582] The Ninth Circuit applied this holding last year to reverse dismissal on SLUSA grounds of a purported class action, brought by the beneficiary of an irrevocable trust against the trustee of that trust, asserting state law claims for breach of fiduciary duty in making self-interested investment decisions and charging excessive fees.[583] The trustee had "sole discretion" over management of the trust assets.[584] Accordingly, the plaintiff beneficiary was herself "unable to purchase or sell covered securities."[585] Indeed, the complaint alleged that she "had no control over how [the trustee] invested the trust's assets."[586]

The plaintiff alleged that the trustee put trust assets into funds affiliated with the trustee, instead of into better performing vehicles.[587] But this asserted wrongdoing "resulted only in [the trustee]—and no other party—purchasing [the] affiliated funds."[588] Thus, the complaint did not allege that the wrongdoing was "'in connection with' any purchase or sale of covered securities by anyone *other than [the alleged fraudster]*" and, under the Supreme Court's rule, SLUSA did not preclude the case.[589] The court then held that other claims—alleging that the trustee "charged improper and excessive fees for 'routine preparation of fiduciary tax returns' and failed to maintain records to justify these

579. *See infra* notes 582–91 and accompanying text.
580. *See infra* notes 592–602 and accompanying text.
581. *See infra* notes 603–16 and accompanying text.
582. Chadbourne & Parke LLP v. Troice, 571 U.S. 377, 387 (2014) (emphasis added).
583. Banks v. N. Tr. Corp., 929 F.3d 1046, 1048–49, 1056 (9th Cir. 2019), *cert. denied*, 140 S. Ct. 1243 (2020) (mem.); *see* Banks v. N. Tr. Corp., CV 16-9141-JFW (JCx), 2017 WL 3579551, at *6 (C.D. Cal. July 14, 2017) (lower court dismissing solely on SLUSA preclusion).
584. *N. Tr. Corp.*, 929 F.3d at 1049.
585. *Id.* at 1052.
586. *Id.* at 1053.
587. *Id.* at 1049.
588. *Id.* at 1052.
589. *Id.* at 1053–54 (emphasis added).

expenses"—also survived a SLUSA-preclusion challenge.[590] These "fee claims . . . lack[ed] any plausible relationship to covered securities" and did "not allege conduct in relation to any securities transactions."[591]

The "covered class action" criterion: a representative action on behalf of less than fifty-one plaintiffs. The fifth criterion for SLUSA preclusion is that the plaintiff has brought a "covered class action." A "covered class action" is a lawsuit that fits either of two definitions.[592] The first—which has two parts—provides that a "single lawsuit" is a "covered class action" if (i) "damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members" or (ii) the single lawsuit "seek[s] to recover damages on a representative basis on behalf of [the named plaintiffs] and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members."[593]

The Seventh Circuit interpreted the second part of this first definition in *Nielen-Thomas v. Concorde Investment Services, LLC*.[594] The plaintiff brought a class action on behalf of clients of a particular investment adviser, alleging that the adviser put client money into (i) block trades unsuitable for retail customers and (ii) an exchange-traded VXX, held in the accounts for such long periods that the investment "was practically guaranteed to lose money."[595] After the defendants removed the case from state court, the district court found the action precluded by SLUSA and dismissed it, even though the plaintiff expressly pled "that 'upon information and belief, the putative Class consists of at least 35, but no more than 49 members.'"[596]

Affirming,[597] the Seventh Circuit noted that the two parts of the first definition of "covered class action" constitute alternatives—(i) a "single lawsuit" in which "damages are sought on behalf of more than 50 persons or prospective class members" or (ii) a "single lawsuit" in which "one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated"—with only the first of these two alternatives including the "more than 50 persons or prospective class members"

590. *Id.* at 1049, 1055.

591. *Id.* at 1055. The plaintiff also pled elder abuse. *Id.* at 1056. Without elaboration, the court of appeals ruled that "SLUSA does not preclude the elder abuse claims." *Id.*

592. 15 U.S.C. §§ 77p(f)(2)(A), 78bb(f)(5)(B) (2018).

593. *Id.* §§ 77p(f)(2)(A)(i), 78bb(f)(5)(B)(i).

594. 914 F.3d 524 (7th Cir. 2019).

595. *Id.* at 526 (identifying VXX as "an unsecured debt instrument designed to track the movement of futures on an index that measures overall market volatility").

596. Nielen-Thomas v. Concorde Inv. Serv., LLC, No. 18-cv-229-jdp, 2018 WL 3598511, at *2, *4 (W.D. Wis. July 26, 2018).

597. *Nielen-Thomas*, 914 F.3d at 526, 535.

numerical threshold.[598] Accordingly, the second alternative "includes all putative class actions that otherwise meet the relevant requirements in its scope, regardless of this proposed class's size."[599] While this reading meant that the two alternatives "include[] some overlap" because "a putative class action in which the proposed class exceeds fifty members could be 'covered' under both," that "redundancy is not unusual or problematic."[600]

Significance and analysis. The Seventh Circuit observed that "[n]o other circuit has directly opined on the difference between [the alternatives in SLUSA's first definition of 'covered class action.']"[601] It added that "[a]n obvious implication of our . . . interpretation is that no putative securities class actions that are based on state law and otherwise meet SLUSA's requirements (they involve a covered security, allege a misrepresentation in connection with that security, etc.) can proceed in either federal or state court under SLUSA."[602]

The "covered class action" criterion: state law claims filed by opt-outs from federal securities class actions. SLUSA's second definition of a "covered class action" includes "any group of lawsuits [(i)] filed in or pending in the same court and [(ii)] involving common questions of law or fact, in which—[(iii)] damages are sought on behalf of more than 50 persons; and [(iv)] the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose."[603] Since "and" connects the subparts of this second definition, that definition requires that the lawsuits meet all four of the listed conditions. In 2019, the Third Circuit considered whether opt-outs from class actions, who filed their lawsuits after the class actions settled with judgments, were, together with those class actions, a "covered class action" within the meaning of this second definition.[604]

Investors sued Merck and Schering-Plough, alleging that those companies' delay in releasing negative results from clinical testing of two drugs (Vytorin and Zetia) constituted a securities fraud.[605] The trial court granted class certification and approved notices giving members of the classes until March 1, 2013 to opt out.[606] After that date, the trial court approved settlement agreements between the defendants and the classes, then entered final judgments in the class actions.[607]

After those judgments were entered, sixteen class members who had timely opted out filed their own lawsuits against Merck and Schering-Plough, asserting federal securities law claims and a state common law fraud claim as well.[608] Following a Third Circuit ruling that *American Pipe* tolling did not lengthen the statute of repose applicable to those federal claims, the district court dismissed them

598. *Id.* at 529–30.
599. *Id.* at 530.
600. *Id.*
601. *Id.* at 531 n.8.
602. *Id.* at 532.
603. 15 U.S.C. §§ 77p(f)(2)(A)(ii), 78bb(f)(5)(B)(ii) (2018).
604. N. Sound Capital LLC v. Merck & Co., 938 F.3d 482 (3d Cir. 2019).
605. *Id.* at 484.
606. *Id.* at 485.
607. *Id.*
608. *Id.*

as untimely filed.[609] At that point, only the opt-outs' state common law fraud claim remained.[610] Merck then moved to dismiss on the ground that SLUSA precluded that last claim.[611]

Since the opt-out cases included a total of sixteen plaintiffs and were not representative actions but brought only on behalf of the named plaintiffs, they did not fit within SLUSA's first definition of a "covered class action."[612] The opt-out cases could only satisfy the third requirement (seeking relief on behalf of more than fifty plaintiffs) of the second definition if they could be sufficiently connected with the class actions (which themselves had more than fifty class members) so as to be, in the words of the fourth requirement, "joined, consolidated, or otherwise proceed[ing with those class actions] as a single action for any purpose."[613]

Reversing the district court's dismissal,[614] the Third Circuit held that the opt-out actions did not meet the third and fourth requirements because they were not "combined," with the class actions, "for the joint management of a common stage of the proceedings (such as discovery) or the resolution of a common question of law or fact."[615] Indeed, they could not have been because the class actions ended before the opt-out lawsuits were ever filed.[616]

Miscellaneous. The Seventh Circuit held that allegedly fraudulent tax shelter advice was not "in connection with" stock sales, the gains from which the shelter sought to shield from taxation.[617] The Second Circuit held that an issuer's factual statements about a contractual counterparty did not impose on the issuer a duty to advise investors that the prospects for contract renewal had deteriorated when the CEO of the counterparty—in discussions between the two companies—compared the issuer to a supplier of ketchup, who would be replaced if another firm offered better terms.[618] Applying the Act of State doctrine, the Ninth Circuit

609. *Id.* at 486.

610. *Id.*

611. *Id.*

612. 15 U.S.C. § 78bb(f)(5)(B)(i) (2018).

613. *Id.* at 488 ("Thus, this appeal turns on the fourth prong of the mass-action provision: whether the class actions and these subsequent opt-out suits were 'joined, consolidated, or otherwise proceed[ed] as a single action for any purpose.'" (alteration by the court)). The opt-out plaintiffs did not dispute the first two requirements, conceding that they filed their lawsuit in the same U.S. district court as the class actions and that their claims involved "substantially the same facts" as the class actions. *Id.*

614. *Id.* at 494.

615. *Id.* at 489.

616. *Id.* at 489–90.

One member of the panel dissented. *Id.* at 494–502 (Shwartz, J., dissenting). She concluded that the opt-out cases displayed "'indicia of coordination'" with the class actions, *id.* at 501 (quoting Stichting Pensioenfonds ABP v. Merck & Co., Civ. No. 05-5060 (SRC), 2012 WL 3235783, at *15 (D.N.J. Aug. 1, 2012)), including: (i) nearly identical complaints, (ii) with state law claims that mirrored the federal claims in the class actions, (iii) plaintiff certifications "that their complaints were the 'subject of the Vytorin Class Action,'" and (iv) markings on "their civil cover sheet as 'related' to the Vytorin Class Actions." *Id.*

617. Menzies v. Seyfarth Shaw LLP, 943 F.3d 328, 333–36 (7th Cir. 2019), *cert. denied*, 2020 WL 1906597 (U.S. Apr. 20, 2020) (No. 19-1125) (mem.).

618. Pipefitters Union Local 537 Pension Fund v. Am. Express Co., 773 F. App'x 630, 632–33 (2d Cir. 2019).

affirmed dismissal of a Rule 10b-5 action in which investors alleged that an issuer deceived by failing to disclose facts that assertedly undercut a favorable transfer-tax ruling that the issuer had obtained from the Mexican tax authority.[619] The Third Circuit held that nonvoting board observers were not proper defendants on a claim under Securities Act section 11.[620]

The D.C. Circuit rejected a petition to review an SEC rule permitting mutual funds to post reports on their websites instead of always delivering them in hard copy, ruling that the consumer advocacy group on the petition had no standing because it failed to supply an affidavit showing that the rule injured any particular one of its members and that a paper company and a paper industry organization had no standing because they were neither among the intended beneficiaries of the securities laws under which the Commission issued the rule nor did their interests coincide with those of the shareholders who were.[621] That same court rejected a First Amendment challenge to, and other attacks on, a Financial Industry Regulatory Authority rule that prohibits placement agents from soliciting investment advisory engagements for investment advisor firms, where the solicitation is directed to (i) government officials who can influence the choice of investment advisor for a government pension fund and (ii) to whose campaign, transition, or inauguration expenses the placement agent has contributed within the preceding two years.[622] The Second Circuit held that a mutual fund had not violated an anti-concentration policy expressly linked to regulatory guidance from the SEC when healthcare assets held by the fund increased in value and, as a result of this passive increase, came to constitute more than 25 percent of total fund assets.[623] The Tenth Circuit held that mandatory deduction of a number of shares, when restricted stock vested, to cover the withholding tax obligation of the issuer was not a "sale" of securities for section 16(b) purposes where the deduction was required by restricted stock agreements approved by the company's compensation committee.[624]

619. Royal Wulff Ventures LLC v. Primero Mining Corp., 938 F.3d 1085 (9th Cir. 2019).

620. Obasi Inv. LTD v. Tibet Pharm., Inc., 931 F.3d 179 (3d Cir. 2019).

621. Twin Rivers Paper Co. v. SEC, 934 F.3d 607 (D.C. Cir. 2019).

622. N.Y. Republican State Comm. v. SEC, 927 F.3d 499 (D.C. Cir. 2019), *cert. denied*, 140 S. Ct. 908 (2020) (mem.).

623. Edwards v. Sequoia Fund, Inc., 938 F.3d 8 (2d Cir. 2019).

624. Olagues v. Muncrief, 760 F. App'x 620 (10th Cir. 2019).