Annual Review of Federal Securities Regulation

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

Contents

* Anna T. Pinedo, Chair, is a member of the New York bar, a partner in the Corporate & Securities practice at Mayer Brown LLP in New York, and an adjunct professor at the George Washington University Law School. Ana M. Estrada is a member of the Texas bar and an associate at Mayer Brown LLP in Houston. William O. Fisher is a member of the California bar and a former partner of Pillsbury Winthrop LLP in San Francisco. Karen J. Garnett is a member of the Washington, DC and Arkansas bars and a Managing Director, Head of ESG Policy and Reporting, The Charles Schwab Corporation. Christina M. Thomas is a member the New York bar and a partner at Mayer Brown LLP in Washington DC and New York.

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 2021. 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.

Given the changes in administration, the new chair of the U.S. Securities and Exchange Commission (the "Commission"), Gary Gensler, was not confirmed until April 2021. As a result, during 2021, much of the Commission's rulemaking activity was undertaken toward the latter half of the year. The Commission proposed a number of rules relating to such matters as the reporting of securities loans, share repurchase disclosure modernization, money market reforms, and the reporting of security-based swap positions. However, there were few final regulations adopted during the 2021 calendar year.

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.

Regulatory Developments 2021

A. The Holding Foreign Companies Accountable Act

On December 18, 2020, President Donald J. Trump signed the Holding Foreign Companies Accountable Act (the "HFCA Act") into law, which mandates new disclosure requirements for certain foreign issuers and prohibits the trading of certain foreign issuers' securities in the United States.[1] The HFCA Act received bipartisan support in Congress following years of escalating tensions between the United States and China.

The HFCA Act aims to address restrictions China has placed on the ability of the Public Company Accounting Oversight Board (the "PCAOB") to inspect or investigate PCAOB-registered public accounting firms in connection with their audits of Chinese issuers listed on U.S. securities exchanges. The Sarbanes-Oxley Act of 2002 created the PCAOB "to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[2] Specifically, the PCAOB is responsible for registering public accounting firms, establishing standards applicable to the preparation of audit reports for companies, conducting inspections and investigations of public accounting firms to ensure they are complying with those standards, and bringing enforcement actions when they are not.[3]

The Sarbanes-Oxley Act requires that both domestic and foreign audit firms that prepare or issue an audit opinion for a company that issues securities in the United States produce the underlying audit work papers at the request of the PCAOB or the Securities and Exchange Commission (the "SEC" or "Commission").[4] For more than a decade, Chinese law has restricted the ability of the SEC and PCAOB to access the audit work papers of China-based issuers listed on U.S. exchanges.[5]

1. Pub. L. No. 116-222, 134 Stat. 1063 (2020).
2. 15 U.S.C. § 7211(a) (2018).
3. *Id.* § 7211(c).
4. *See id.* §§ 7214, 7216.
5. President's Working Grp. on Fin. Mkts., Report on Protecting United States Investors from Significant Risks from Chinese Companies 2, app. A (July 24, 2020), https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf.

The HFCA Act amends the Sarbanes-Oxley Act and directs the SEC to identify public companies that use an audit firm that has a branch or office that:

(1) is located in a foreign jurisdiction; and

(2) authorities in that foreign jurisdiction restrict the PCAOB's ability to inspect or investigate the audit firm (as determined by the PCAOB).[6]

Any identified issuer must comply with additional submission-and-disclosure requirements and may face a trading prohibition if, for three consecutive years, the PCAOB is unable to fully inspect or investigate the issuer's audit firm.[7]

B. SEC and PCAOB Implementing Rules

The HFCA Act requires certain PCAOB and SEC actions in order to carry out the mandates in the legislation, which resulted in several rulemakings and other official actions in 2021. First, the SEC adopted interim final rules on March 18, 2021 to implement the disclosure requirements in the HFCA Act.[8] The amendments to the SEC's annual report forms that set forth the new disclosure requirements were not proposed pursuant to the Administrative Procedure Act because the SEC determined that doing so would be impractical and unnecessary in light of the HFCA Act's ninety-day implementation mandate and prescriptive disclosure requirements. While, as a result, no notice-and-comment period was required, the SEC requested that market participants and other members of the public provide feedback on the implementation of the new rules. The expectation was that the SEC would subsequently propose rules to implement the trading prohibition required by the HFCA Act. This expectation was, in part, based on the language in the interim final rules release, which stated that "[t]he Commission staff, in deciding what to recommend to the Commission, is actively considering ways to implement the trading prohibition, and the Commission anticipates seeking comment from the public."[9]

Next, the PCAOB adopted PCAOB Rule 6100, *Board Determinations Under the Holding Foreign Companies Accountable Act*, on September 22, 2021.[10] PCAOB Rule 6100, which was approved by the SEC on November 4, 2021,[11] creates a framework for the PCAOB to make its determinations regarding its ability to

6. Pub. L. No. 116-222, § 2, 134 Stat. at 1064.

7. *See id.*

8. HFCA Act Disclosure, 86 Fed. Reg. 17528 (Apr. 5, 2021) (to be codified at 17 C.F.R. pts. 249, 274).

9. *Id.* at 17529 n.9.

10. *See* Rule Governing Board Determinations Under the Holding Foreign Companies Accountable Act, PCAOB Release No. 2021-004 (Sept. 22, 2021); https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket048/2021-004-hfcaa-adopting-release.pdf?sfvrsn=f6dfb7f8_4 [hereinafter PCAOB Adopting Release].

11. Pub. Co. Acct. Oversight Bd., Order Granting Approval of Proposed Rule Governing Board Determinations Under the HFCA Act, Exchange Act Release No. 93527 (Nov. 4, 2021), https://sec.gov/rules/pcaob/2021/34-93527.pdf.

inspect or investigate audit firms as required by the HFCA Act. Specifically, Rule 6100 provides that the PCAOB will consider various factors and issue a report to the SEC with its determinations as to which public accounting firms in which jurisdictions the PCAOB is unable to fully inspect or investigate ("PCAOB-Identified Firms").[12] The PCAOB will provide its report to the public and reevaluate its determinations at least annually. The SEC will then be able to use this report to identify the issuers whose audits were conducted by the PCAOB-Identified Firms, referred to by the SEC as "Commission-Identified Issuers."[13]

On December 2, 2021, the SEC adopted amendments to finalize the interim final rules, at the same time unexpectedly adopting final rules to implement the HFCA Act's trading prohibition without the anticipated notice-and-comment process.[14] Two weeks later, the PCAOB published its first report on December 16, 2021, identifying registered public accounting firms in mainland China and Hong Kong as PCAOB-Identified Firms.[15] With respect to next steps, the SEC's adopting release explains:

> [T]he Commission will identify registrants pursuant to the HFCA Act based on the PCAOB's determination and on registrants' annual reports for fiscal years beginning after December 18, 2020. The earliest that the Commission could identify a Commission-Identified Issuer would be after registrants file their annual reports for 2021 and identify the accounting firm that audited their financial statements.[16]

Once identified, Commission-Identified Issuers will be listed on the SEC's website and the fiscal year for which each issuer is identified will be considered a "non-inspection year."[17] A Commission-Identified Issuer's annual report filed in the following year will cover that non-inspection year.

1. Disclosure-and-Submission Requirements

Each Commission-Identified Issuer will be required to submit to the SEC, via its Electronic Data Gathering, Analysis, and Retrieval system, documentation establishing that the issuer is not owned or controlled by a governmental entity in the foreign jurisdiction of the PCAOB-Identified Firm.[18] Commission-Identified Issuers must also provide certain disclosures regarding their ownership and any ties to the Chinese Communist Party during each non-inspection year in which a PCAOB-Identified Firm has prepared an audit report. The disclosures are required to be included in the Commission-Identified Issuer's annual report covering the non-inspection year filed with the SEC. The SEC's annual report forms—Form

12. PCAOB Adopting Release, *supra* note 10, at 29–31.
13. HFCA Act Disclosure, 86 Fed. Reg. 70027, 70032–33 (Dec. 9, 2021) (to be codified at 17 C.F.R. pts. 200, 232, 249).
14. *Id.* at 70032–36.
15. *See* HFCAA Determination Report, PCAOB Release No. 104-HFCAA-2021-001 (Dec. 16, 2021), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/international/documents/104-hfcaa-2021-001.pdf?sfvrsn=acc3b380_4.
16. HFCA Act Disclosure, 86 Fed. Reg. at 70031.
17. *Id.* at 70032–33.
18. Pub. L. No. 116-222, §§ 2–3, 134 Stat. 1063, 1063–66.

10-K, Form 20-F, and Form 40-F—have been amended to include a new line-item requirement that prescribes this disclosure.

2. Mandatory Trading Prohibition

If the SEC determines that a company has three consecutive non-inspection years, the HFCA Act requires that the SEC prohibit the securities of the company from being traded on a national securities exchange or through any other method regulated by the SEC, including over-the-counter trading.[19] The legislation allows for the removal of the trading prohibition if the issuer later "certifies to the Commission that the covered issuer has retained a registered public accounting firm that the [PCAOB] has inspected under this section to the satisfaction of the Commission."[20] However, if the issuer subsequently falls out of compliance again—even for having just one non-inspection year—the issuer must wait another five years before it can apply to have the subsequent prohibition removed.

The process adopted by the SEC provides that a list of all Commission-Identified Issuers will be made available to the public on the SEC's website, along with the number of consecutive years in which each such issuer has been a Commission-Identified Issuer, and any prior trading prohibitions applied to such issuer. Upon the public identification of an issuer as a Commission-Identified Issuer for the third consecutive year, the SEC will issue an order prohibiting trading. Such order will become effective on the fourth business day after publication. The SEC did not adopt any additional rules, or amend any existing rules, to further implement or facilitate a trading prohibition or de-listing from a national securities exchange. Instead, the SEC explained in a footnote that "the existing rules of national securities exchanges that list issuers that are subject to an initial trading prohibition are applicable to delisting of such issuers' securities, as appropriate."[21] Thus, it appears that U.S. securities exchanges, such as the New York Stock Exchange and Nasdaq, as well as the over-the-counter markets, will have to determine how best to implement trading prohibitions required by the HFCA Act. The PCAOB has provided the following information, which puts the scope of expected de-listings into context:

> In the thirteen month period ended December 31, 2021, 15 PCAOB-registered firms in mainland China and Hong Kong signed audit reports for 192 public companies with a combined global market capitalization (U.S. and non-U.S. exchanges) of approximately $1.7 trillion. The ten largest of these companies had a combined market capitalization of approximately $1.1 trillion.[22]

While the trading prohibition applies to the securities of the issuer, compliance with the HFCA Act and its implementing rules is largely outside of the control of

19. *Id.* § 2, 134 Stat. at 1064.
20. *Id.*
21. HFCA Act Disclosure, 86 Fed. Reg. at 70034 n.85.
22. *China-Related Access Challenges*, Pub. Co. Acct. Oversight Bd., https://pcaobus.org/oversight/international/china-related-access-challenges (last visited Apr. 1, 2022).

the issuer. Rather, the rules apply to the accounting firm that audits the issuer's financial statements. For this reason, it is expected that, unless China and Hong Kong abandon their policy of restricting PCAOB inspections and investigations of accounting firms in their respective jurisdictions, issuers based in China and Hong Kong will face de-listing in 2024.[23]

23. HFCA Act Disclosure, 86 Fed. Reg. at 70034 n.74.

Accounting Developments 2021

In 2021, the Financial Accounting Standards Board (the "FASB" or the "Board") issued ten Accounting Standards Updates ("ASUs") to its Accounting Standards Codification ("ASC" or the "Codification"), compared to eleven ASUs in 2020. Two of the ASUs issued in 2021 clarify the scope and application of standards related to reference rate reform[1] and business combinations.[2] Two ASUs make improvements to the leases standard in response to input received as part of the Board's ongoing post-implementation review of that standard, which was adopted in 2016.[3] Two ASUs provide new practical expedients related to revenue recognized by franchisors[4] and stock compensation.[5] One ASU creates a new accounting alternative related to goodwill impairment analysis.[6] The practical expedients and the accounting alternative apply only to nonpublic entities. One ASU issued in 2021 revises various sections of the Codification to reflect amendments to the U.S. Securities and Exchange Commission's ("SEC") financial reporting rules in Regulation S-X and a new subpart to Regulation S-K related to disclosure by bank and savings and loan registrants adopted by the SEC.[7] One ASU issued in 2021 adds a new Codification Topic to improve transparency about government assistance.[8]

The FASB issued one ASU that articulates a consensus of the FASB's Emerging Issues Task Force (the "EITF")[9] and one that articulates a consensus of the FASB's Private Company Council (the "PCC").[10]

The EITF, which was formed in 1984, seeks to address emerging accounting issues before divergent approaches to those issues become widespread.[11] The FASB must approve all consensuses reached by the EITF. The EITF is chaired by the FASB's technical director, has members from the auditing profession and from the preparer and financial statement user communities, and observers from the FASB board, the SEC, the Financial Reporting Executive Committee

1. *See infra* section A.1.
2. *See infra* section A.6.
3. *See infra* sections A.4, A.7.
4. *See infra* section A.2.
5. *See infra* section C.
6. *See infra* section A.3.
7. *See infra* section A.5.
8. *See infra* section A.8.
9. *See infra* section B.
10. *See infra* section C.
11. *Emerging Issues Task Force (EITF), About the EITF*, Fin. Acct. Standards Bd., https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137512 (last visited Mar. 15, 2022).

of the American Institute of Certified Accountants (the "AICPA"), and the PCC.[12]

The PCC was formed by the Board of Trustees of the Financial Accounting Foundation (the "FAF") in May 2012 to improve the process of setting accounting standards for private companies. The PCC determines whether exceptions or modifications to U.S. 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.[13] The PCC also is responsible for advising the FASB on the appropriate treatment for private companies for items on the FASB's technical agenda.[14] The FASB must endorse any proposed exceptions or modifications to GAAP proposed by the PCC.[15] Similar to the EITF, the PCC's members represent the auditing profession, preparers and financial statement users, and they must have significant experience conducting audits or preparing or using private company financial statements.[16] A FASB board member serves as liaison to the PCC, and the FASB staff provides technical and administrative support to the PCC.[17]

The following discussion summarizes the ASUs issued by the FASB in 2021.

A. ASUs Originated by the FASB

1. Reference Rate Reform—Scope

On January 7, 2021, the FASB issued ASU No. 2021-01[18] to clarify the scope of the Board's reference rate reform guidance in ASC Topic 848, Reference Rate Reform.[19] The FASB issued ASC 848 in 2020 to "ease the potential burden on financial reporting in accounting for (or recognizing the effect of) reference rate reform."[20] To achieve this objective, ASC 848 provides "temporary, optional expedients and exceptions for applying accounting guidance to contract modifications and hedging relationships . . . that reference LIBOR or another reference rate expected to be discontinued."[21] ASU 2021-01 clarifies that certain optional expedients and exceptions in ASC 848 may be applied to derivative instruments that do not reference LIBOR or another rate being discontinued but that use an interest rate for margining, discounting, or contract price alignment that is

12. *Id.*
13. *Private Company Council (PCC), History of Establishing the PCC*, Fin. Acct. Standards Bd., https://www.fasb.org/pcc/history (last visited Mar. 15, 2022).
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-01, Reference Rate Reform (Topic 848) (Jan. 2021) [hereinafter ASU 2021-01].
19. *Accounting Standards Codification 848, Reference Rate Reform*, Fin. Acct. Standards Bd., https://asc.fasb.org/topic&trid=122150588 (last visited Mar. 15, 2022) [hereinafter ASC 848].
20. ASU 2021-01, *supra* note 18, at 29 (BC2).
21. FASB Media Advisory 01-07-21, FASB Clarifies Scope of Recent Reference Rate Reform Guidance; *see also* Fin. Acct. Standards Bd., Accounting Standards Update No. 2020-04, Reference Rate Reform (Topic 848) (Mar. 2020) [hereinafter ASU 2020-04].

modified as a result of reference rate reform (commonly referred to as the "discounting transition").[22]

Currently, the guidance in ASC 848 applies to "contracts or other transactions that reference [LIBOR] or a reference rate that is expected to be discontinued as a result of reference rate reform."[23] In its continuing effort to monitor global developments in reference rate reform, the Board noted market-wide changes in derivative instruments related to the discounting transition.[24] Stakeholders questioned whether the guidance in ASC 848 could also apply to derivatives that are affected by reference rate reform as a result of the discounting transition but do not reference a rate that is expected to be discontinued.[25] The FASB recognized that the current scope of ASC 848 could preclude its application to such derivative instruments, even though changes being made to those instruments also stem from reference rate reform.[26]

ASU 2021-01 expands the scope provisions in ASC 848 to apply the guidance explicitly to derivative instruments that are affected by reference rate reform as a result of the discounting transition.[27] The expanded scope will allow "both derivatives that reference a rate that is expected to be discontinued as a result of reference rate reform and those that reference a rate that is expected to continue after reference rate reform that are affected by the discounting transition" to apply the contract modification relief in ASC 848.[28] Similarly, certain hedge accounting optional exceptions and expedients can be applied to derivative instruments that are subject to the discounting transition.[29]

The amendments provided by ASU 2021-01 are optional and apply to all entities with derivative instruments that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform.[30] The amendments were effective as of January 7, 2021, and generally will be available through December 31, 2022, as follows:

> An entity may elect to apply the amendments . . . on a full retrospective basis as of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020, or on a prospective basis to new modifications from any date within an interim period that includes or is subsequent to the date of the issuance of a final Update, up to the date that financial statements are available to be issued.[31]

The amendments will not apply to contract modifications and new hedging relationships entered into after December 31, 2022. Also, the amendments

22. ASC 848, *supra* note 19 (para. 848-10-15-3); *see also* ASU 2021-01, *supra* note 18, at 32 (BC13).
23. ASC 848, *supra* note 19 (para. 848-10-15-3).
24. ASU 2021-01, *supra* note 18, at 29 (BC3).
25. *Id.* at 1–2.
26. *Id.* at 31 (BC11).
27. ASC 848, *supra* note 19 (para. 848-10-15-3A).
28. ASU 2021-01, *supra* note 18, at 32 (BC15).
29. *Id.* at 32 (BC16).
30. *Id.* at 2.
31. *Id.* at 6; *see also* ASC 848, *supra* note 19 (para. 848-10-65-2).

generally will not apply to existing hedging relationships evaluated for effectiveness in periods after December 31, 2022, with certain exceptions.[32]

2. Franchisors—Revenue from Contracts with Customers

In January 2021, the FASB issued ASU No. 2021-02[33] to simplify the application of revenue recognition guidance for franchisors that are not public business entities. The FASB issued ASU 2021-02 to address stakeholder concerns about the complexity of applying the guidance in ASC Topic 606, Revenue from Contracts with Customers,[34] to pre-opening services.[35] The Board expects that the amendments will provide financial reporting results "that are generally more consistent with the intent" of ASC 606 for the affected entities.[36]

ASC 606 requires franchisors to analyze pre-operating activities in their franchise agreements to identify whether the goods and services provided are distinct from the franchise license and thus are performance obligations. If the goods and services are performance obligations, then the franchisor must analyze the standalone selling prices for those performance obligations to determine the timing and amount of revenue recognition.[37] Private company stakeholders indicated that "significant costs and complexity are associated with identifying and evaluating performance obligations related to pre-opening services under a franchise agreement."[38] Additionally, some non-public franchisors held an "incorrect view that those pre-opening services always would not be distinct from the franchise license and the initial franchise fee therefore would always be recognized over the license term rather than applying the [ASC 606] model to identify performance obligations."

ASU 2021-02 adds a new subtopic to the standards applicable to franchisors.[39] The new subtopic provides a practical expedient for non-public franchisors to more easily apply the guidance about identifying performance obligations and simplifies the judgment required to determine whether pre-opening services are distinct from the franchise license.[40] The practical expedient allows franchisors that are not public business entities to account for pre-opening services as distinct from the franchise license so long as the services are consistent with those included in a predefined list within the new guidance.[41] The practical expedient applies only to identifying performance obligations. Entities that apply the practical

32. *Id.* at 6.

33. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-02, Franchisors—Revenue from Contracts with Customers (Subtopic 952-606) (Jan. 2021) [hereinafter ASU 2021-02].

34. *Accounting Standards Codification 606, Revenue*, Fin. Acct. Standards Bd., https://asc.fasb.org/subtopic&trid=49130389 (last visited Mar. 15, 2022) [hereinafter ASC 606]; *see also* ASU 2021-02, *supra* note 33, at 17.

35. ASU 2021-02, *supra* note 33, at 17.

36. *Id.* at 2, 19 (BC10).

37. *Id.* at 1.

38. *Id.* at 2.

39. *Accounting Standards Codification 952, Franchisors*, Fin. Acct. Standards Bd., https://asc.fasb.org/subtopic&trid=125985667 (last visited Mar. 15, 2022) [hereinafter ASC 952] (para. 952–606).

40. ASU 2021-02, *supra* note 33, at 22 (BC17).

41. ASC 952, *supra* note 39 (para. 952-06-25-2).

expedient will still need to apply the existing guidance in ASC 606 to determine the timing and amount of revenue recognition.[42] Additionally, entities that elect the practical expedient may make an accounting policy election to recognize the pre-opening services as a single performance obligation, rather than determining whether the pre-opening services are distinct from one another.[43] Non-public franchisors that elect the practical expedient, and entities that make the accounting policy election to recognize pre-opening services as a single performance obligation, will be required to disclose those facts.[44]

The practical expedient is available only to franchisors that are nonpublic business entities.[45] While non-public franchisors expressed concerns about implementation of ASC 606, the Board observed that public franchisors, which adopted ASC 606 before the private franchisors were required to do so, did not raise similar concerns.[46] Entities that do not apply the practical expedient will apply the ASC 606 guidance on identifying performance obligations.[47]

The effective date of the amendments in ASU 2021-02 differ depending on whether an entity has adopted ASC 606. For entities that have already adopted ASC 606, the amendments are effective for annual and interim periods beginning after December 15, 2020, and early adoption is permitted.[48] Those entities will apply the guidance retrospectively to the date ASC 606 was adopted.[49] For entities that have not yet adopted ASC 606, the existing transition and effective date provisions of ASC 606 will also apply to the amendments in ASU 2021-02.[50] The amendments provide "an option of modified retrospective transition or full retrospective transition and an effective date of annual reporting periods beginning after December 15, 2019, and interim periods within annual reporting periods beginning after December 15, 2020."[51]

3. Intangibles—Goodwill and Other

In March 2021, the FASB issued ASU No. 2021-03,[52] which amends ASC Topic 350, Intangibles—Goodwill and Other,[53] to provide an accounting

42. *Id.* (para. 952-06-25-4).
43. *Id.* (para. 952-606-25-3).
44. *Id.* (para. 952-606-01 through -02).
45. *Id.* (para. 952-606-05-1, -15-2).
46. ASU 2021-02, *supra* note 33, at 26 (BC26).
47. ASC 952, *supra* note 39 (para. 952-606-25-4).
48. *Id.* (para. 952-606-65-1).
49. *Id.*
50. In June 2020, the Board delayed the effective date of ASC 606 for all nonpublic entities, including franchisors that are not public entities, to allow the Board to consider the pre-opening services issue. *See* Fin. Acct. Standards Bd., Accounting Standards Update No. 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities (June 2020).
51. ASU 2021-02, *supra* note 33, at 3; ASC 952, *supra* note 39 (para. 952-606-65-1).
52. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-03, Intangibles—Goodwill and Other (Topic 350) (Mar. 2021) [hereinafter ASU 2021-03].
53. *Accounting Standards Codification 350, Intangibles—Goodwill and Other,* Fin. Acct. Standards Bd., https://asc.fasb.org/topic&trid=2144416 (last visited Mar. 15, 2022) [hereinafter ASC 350].

alternative for evaluating triggering events related to goodwill impairment. The amendments allow private companies and not-for-profit entities to perform the goodwill impairment triggering event evaluation as of the end of the quarterly or annual reporting period, rather than evaluating triggering events throughout the reporting period.[54] The amendments are intended to simplify the triggering event evaluation by allowing entities to elect an accounting alternative that aligns the goodwill triggering event evaluation with the reporting date and other reporting processes.[55]

Generally, ASC 350 requires an entity to monitor and evaluate goodwill impairment triggering events throughout the reporting period.[56] An entity must evaluate whether a triggering event has occurred and, if so, the entity must test goodwill for impairment.[57] A triggering event is an event or change in circumstances "that would more likely than not reduce the fair value of a reporting unit (or in some cases entity) below its carrying amount."[58] The amendments provide an accounting alternative for private companies and not-for-profit entities to complete the goodwill impairment triggering event analysis at the end of the interim or annual period rather than during the period, as otherwise required under ASC 350.[59]

The Board decided to issue the amendments in response to concerns expressed by certain stakeholders about the cost, complexity, and relevance of private companies and not-for-profit entities preparing a goodwill triggering event evaluation during the reporting period rather than as of the end of the reporting period.[60] Stakeholders noted that private companies often perform the triggering event analysis at the end of their annual reporting process, making it "difficult for them to determine whether there was a triggering event during the year and, if so, the precise date on which the triggering event occurred."[61] Stakeholders also questioned the usefulness of private companies performing a goodwill impairment evaluation on the date that a triggering event occurs:

> As an example, . . . if a private company that reports only on an annual basis determines that it has a goodwill triggering event on an interim date but the facts and circumstances that led to the triggering event have changed as of the end of the annual reporting period, an impairment charge estimated as of the date of the triggering event may not provide users of financial statements with meaningful information if the entity reports results only at year end.[62]

The FASB expects that the amendments will reduce compliance costs for private companies and not-for-profit entities that elect the accounting alternative by

54. *Id.* (para. 350-20-15-4A, -35-84).
55. ASU 2021-03, *supra* note 52, at 25–26 (BC 13).
56. ASC 350, *supra* note 53 (para. 350-20-35-30).
57. *Id.*; *see also* ASU 2021-03, *supra* note 52, at 1.
58. ASU 2021-03, *supra* note 52, at 1; *see also* ASC 350, *supra* note 53 (para. 350-20-35-66).
59. ASC 350, *supra* note 53 (para. 350-20-35-84).
60. ASU 2021-03, *supra* note 52, at 1.
61. *Id.* at 24 (BC7).
62. *Id.* (BC8).

allowing those entities "to align the goodwill triggering event evaluation with their other reporting processes, such as calculating debt covenants."[63] Additionally, the FASB anticipates no loss of decision-useful information for investors because "feedback indicated that users of private company and not-for-profit financial statements do not place significant value on non-cash charges like goodwill impairment."[64]

Stakeholders also noted that economic uncertainty resulting from the COVID-19 pandemic highlighted concerns about the timing of goodwill impairment testing because of the significant changes in facts and circumstances from period to period.[65] Accordingly, the FASB considered whether the accounting alternative should be limited to triggering events and reporting periods affected by the pandemic.[66] The Board decided, however, to make the accounting alternative available on an ongoing basis, rather than limiting it to periods affected by the pandemic. In reaching its decision, the Board considered the difficulty of determining what reporting periods have been or will be affected by the pandemic and noted that issues concerning cost, complexity, and user relevance exist regardless of whether an impairment is associated with the pandemic.[67]

The amendments in ASU 2021-03 are effective prospectively for fiscal years beginning after December 15, 2019. Early adoption is permitted for interim and annual financial statements that have not yet been issued or made available for issuance as of March 30, 2021.[68] Retrospective application is not permitted.[69] The amendments also provide that companies and entities that elect the accounting alternative for the first time "need not justify the use of the accounting alternative as preferable" under ASC Topic 250, Accounting Changes and Error Corrections.[70]

4. Leases—Certain Leases with Variable Lease Payments

In July 2021, the FASB issued ASU No. 2021-05,[71] which amends ASC Topic 842, Leases[72] to address an issue related to a lessor's accounting for certain leases with variable lease payments.[73] The amendments affect lessors with lease contracts that "(i) have variable lease payments that do not depend on a reference

63. *Id.* at 25–26 (BC13).
64. *Id.* at 25 (BC12).
65. *Id.* at 1.
66. *Id.* at 32 (BC41).
67. *Id.* (BC44).
68. ASC 350, *supra* note 53 (para. 350-20-65-4).
69. *Id.*
70. *Id.*
71. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-05, Leases (Topic 842) (July 2021) [hereinafter ASU 2021-05].
72. *Accounting Standards Codification 842, Leases,* Fin. Acct. Standards Bd., https://asc.fasb.org/subtopic&trid=77888250 (last visited Mar. 15, 2022) [hereinafter ASC 842].
73. ASU 2021-05, *supra* note 71, at 1. This issue was identified as part of the Board's post-implementation review of ASC 842, which includes "outreach to various stakeholder organizations to address any additional issues that may have arisen since the adoption of [ASC 842] by public business entities." *Id.*

index or a rate and (ii) would have resulted in the recognition of a selling loss at lease commencement if classified as a sales-type or direct financing lease."[74]

As part of the Board's post-implementation review of ASC 842, which was issued in 2016, certain stakeholders have noted that application of the standard to certain leases with variable lease payments can require a lessor to recognize a selling loss at lease commencement (referred to as a "day-one loss") even if the lessor expects the arrangement to be profitable overall. This can result in "reporting outcomes that do not faithfully represent the underlying economics either at lease commencement or over the lease term."[75] ASU 2021-05 summarizes the issue as follows:

> Topic 842 requires that a lessor determine whether a lease should be classified as a sales-type lease or a direct financing lease at lease commencement on the basis of specified classification criteria (see paragraphs 842-10-25-2 through 25-3). Under Topic 842 a lessor is not permitted to estimate most variable payments and must exclude variable payments that are not estimated and do not depend on a reference rate index or a rate from the lease receivable. Subsequently, those excluded variable payments are recognized entirely as lease income when the changes in facts and circumstances on which those variable payments are based occur. Consequently, the net investment in the lease for a sales-type lease or a direct financing lease with variable payments of a certain magnitude that do not depend on a reference index or a rate may be less than the carrying amount of the underlying asset derecognized at lease commencement. As a result, the lessor recognizes a selling loss at lease commencement (hereinafter referred to as a day-one loss) even if the lessor expects the arrangement to be profitable overall.[76]

Additionally, stakeholders noted that lessors did not recognize day-one losses under ASC 840, which preceded the issuance of ASC 842 in 2016, because of a longstanding interpretation of a classification criterion under ASC 840.[77] That classification criterion was not retained in ASC 842.[78]

The Board decided to issue the amendments in ASU 2021-05 to address the stakeholders' concerns by aligning the lease classification requirements with prior practice under ASC 840.[79] The amendments will require a lessor to "classify a lease with variable lease payments that do not depend on an index or a rate as an operating lease at commencement if classifying the lease as a sales-type lease or a direct financing lease would result in the recognition of a selling loss."[80] By classifying the lease as an operating lease, the lessor would not recognize a selling profit or loss.[81]

The amendments are effective for all entities for fiscal years beginning after December 15, 2021. For public business entities, the amendments also apply

74. *Id.*
75. *Id.* at 2.
76. *Id.* at 1–2.
77. *Id.*
78. *Id.*
79. *Id.*
80. ASC 842, *supra* note 72 (para. 842-10-25-3A).
81. ASU 2021-05, *supra* note 71, at 2.

to interim periods within those fiscal years. For all other entities, the amendments apply to interim periods within fiscal years beginning after December 15, 2022.[82] Entities that have not adopted ASC 842 as of July 19, 2021 (the date that ASU 2021-05 was issued) should apply the transition requirements of ASC 842 to these amendments.[83] Entities that adopted ASC 842 before July 19, 2021, have the option to apply the amendments either (i) retrospectively to leases that commence or are modified on or after adoption of ASC 842, or (ii) prospectively to leases that commence or are modified on or after the date the entity first applies these amendments.[84] Early adoption is permitted.

5. Presentation of Financial Statements and Financial Services—Updates to SEC Sections in the Codification

In August 2021, the FASB issued ASU No. 2021-06,[85] which amends ASC Topic 205, Presentation of Financial Statements,[86] ASC Topic 942, Financial Services—Depository and Lending,[87] and ASC Topic 946, Financial Services—Investment Companies.[88] Specifically, the update amends certain SEC paragraphs to reflect recent rule amendments related to financial disclosures for acquired and disposed businesses, which became effective on January 1, 2021.[89] Additional amendments conform to updated SEC rules related to statistical disclosures for banks and savings and loan companies, which generally became effective on November 16, 2020.[90]

6. Business Combinations

In October 2021, the FASB issued ASU No. 2021-08[91] to improve the accounting for revenue contracts with customers acquired in a business combination. Specifically, ASU 2021-08 amends ASC Topic 805, Business Combinations[92] to require an entity (acquirer) to recognize and measure contract assets and contract

82. ASC 842, *supra* note 72 (para. 842-10-65-5).
83. *Id.*
84. *Id.*; *see also* ASU 2021-05, *supra* note 71, at 3.
85. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-06, Presentation of Financial Statements (Topic 205), Financial Services—Depository and Lending (Topic 942), and Financial Services—Investment Companies (Topic 946) (Aug. 2021) [hereinafter ASU 2021-06].
86. *Accounting Standards Codification 205, Presentation of Financial Statements*, Fin. Acct. Standards Bd., https://asc.fasb.org/topic&trid=2122149 (last visited Mar. 15, 2022) [hereinafter ASC 205].
87. *Accounting Standards Codification 942, Financial Services—Depository and Lending*, Fin. Acct. Standards Bd., https://asc.fasb.org/topic&trid=2209208 (last visited Mar. 15, 2022) [hereinafter ASC 942].
88. *Accounting Standards Codification 946, Financial Services—Investment Companies*, Fin. Acct. Standards Bd., https://asc.fasb.org/topic&trid=2303982 (last visited Mar. 15, 2022) [hereinafter ASC 946].
89. Amendments to Financial Disclosures About Acquired and Disposed Businesses, SEC Release No. 33-10786, 85 Fed. Reg. 54002 (Aug. 31, 2020).
90. Update of Statistical Disclosures for Bank and Savings and Loan Registrants, SEC Release No. 33-10835, 85 Fed. Reg. 66108 (Oct. 16, 2020).
91. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-08, Business Combinations (Topic 805) (Oct. 2021) [hereinafter ASU 2021-08].
92. *Accounting Standards Codification 805, Business Combinations*, Fin. Acct. Standards Bd., https://asc.fasb.org/topic&trid=2303972 (last visited Mar. 15, 2022) [hereinafter ASC 805].

liabilities acquired in a business combination in accordance with ASC Topic 606, Revenue.[93] The amendments provide consistent recognition and measurement guidance for revenue contracts with customers, regardless of whether those contracts are acquired in a business combination or originated by the entity.[94]

The amendments address diversity in practice about how to determine whether a contract liability is recognized by the acquirer in a business combination. Under ASC 805, an acquirer generally recognizes assets acquired and liabilities assumed in a business combination at fair value on the acquisition date, in accordance with ASC Topic 820, Fair Value Measurement.[95] ASC 606, which was issued in 2014, provides a single accounting model on revenue recognition for contracts with customers. Before the adoption of ASC 606, an acquirer would recognize a liability for deferred revenue if it represented a legal obligation, rather than applying the concept of performance obligation introduced in ASC 606.[96] Stakeholders have raised questions about how to apply ASC 805 to contracts with a customer acquired in a business combination after the acquirer has adopted ASC 606.[97] The amendments also address questions about how to recognize and measure acquired revenue contracts with customers at the date of and following a business combination.[98]

The amendments in ASU 2021-08 create new exceptions to the recognition and measurement principles of ASC 805.[99] Under the new exceptions, an acquiring entity must apply ASC 606, rather than the general principles under ASC 805, to recognize and measure contract assets and contract liabilities acquired in a business combination.[100]

The amendments also provide specific guidance on recognition and measurement for contract assets and contract liabilities of an acquired contract.[101] At the acquisition date, an acquirer should account for the related revenue contracts in accordance with Topic 606 as if it had originated the contracts.[102] To achieve this, the Board noted, an acquirer may assess how the acquiree applied Topic 606 to determine what to record for the acquired revenue contracts. Generally, the new guidance should "result in an acquirer recognizing and measuring the acquired contract assets and contract liabilities consistent with how they were recognized and measured in the acquiree's financial statements (if the acquirer prepared financial statements in accordance with [GAAP])."[103] As a result of measuring contract assets and contract liabilities arising from revenue contracts

93. ASC 606, *supra* note 34.
94. ASU 2021-08, *supra* note 91, at 3, 18 (BC19).
95. *Id.* at 15 (BC11).
96. *Id.* at 1.
97. *Id.*
98. *Id.* at 3.
99. ASC 805, *supra* note 92 (para. 805-20-25-28C, -30-27). The exceptions also apply to other contracts to which the provisions of Topic 606 apply. *Id.*
100. *Id.*; *see also* ASU 2021-08, *supra* note 91, at 1.
101. ASC 805, *supra* note 92 (para. 805-20-30-28).
102. *Id.*
103. ASU 2021-08, *supra* note 91, at 2.

from customers acquired in a business combination in accordance with ASC 606, "the acquirer should no longer measure the remaining obligations of the acquired revenue contract at fair value but, instead, utilize the transaction price allocated to the remaining performance obligations in accordance with the principles of [ASC] 606."[104]

The amendments include certain practical expedients to provide relief to acquirers that do not have "the appropriate data or expertise to analyze the historical periods in which the contract was entered into."[105] These situations could arise when the acquirer has to assess long-term, contracts that were modified prior to the business combination or when the acquirer is unable to assess or rely on the acquiree's accounting under ASC 606.[106] The practical expedients address (1) contracts that were modified before the acquisition date, and (2) the date for determining the standalone selling price of each performance obligation in the acquired contract.[107] If the acquirer elects a practical expedient, the acquirer must apply that practical expedient consistently to all contracts acquired in the same business combination and provide related disclosures.[108]

For public business entities, the amendments will be effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2022. For all other entities, the amendments will be effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2023.[109] The amendments should be applied prospectively to business combinations that occur after the effective date, and early application is permitted.[110] An entity that elects early application for an interim period must apply the amendments retrospectively to all business combinations that occur on or after the beginning of the fiscal year that includes the interim period of adoption, as well as prospectively for all business combinations that occur after the date of initial application.[111]

7. Leases—Discount Rate for Lessees that Are Not Public Business Entities

In August 2021, the FASB issued ASU No. 2021-09,[112] to amend an existing practical expedient under ASC 842, Leases, which previously allowed lessees that are not public business entities to elect, as an accounting policy, to use a risk-free rate as the discount rate for all leases.[113] The amendments provide non-public lessees greater flexibility to make the election by class of underlying

104. *Id.* at 20–21 (BC30).
105. *Id.* at 23 (BC35).
106. *Id.* at 22 (BC34).
107. ASC 805, *supra* note 92 (para. 805-20-30-29); *see also* ASU 2021-08, *supra* note 91, at 1.
108. ASC 805, *supra* note 92 (para. 805-20-30-30).
109. *Id.* (para. 805-20-65-3a, b).
110. *Id.* (para. 805-20-65-3c, d).
111. *Id.* (para. 805-20-65-3e).
112. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-09, Leases (Topic 842) (Nov. 2021) [hereinafter ASU 2021-09].
113. *Id.* at 2.

asset, rather than at the entity-wide level.[114] The amendments apply to all lessees that are not public business entities, including all not-for-profit entities and employee benefit plans.[115]

A lessee's discount rate "directly affects lease classification and the measurement of a lessee's lease liability and corresponding right-of-use asset" and in some cases will affect the income statement.[116] ASC 842 generally requires a lessee to use the rate implicit in the lease whenever that rate is readily determinable to discount its leases and to use the lessee's incremental borrowing rate when the rate implicit in the lease is not readily determinable.[117] As a practical expedient, ASC 842 previously allowed lessees that are not public business entities to avoid calculation of the incremental borrowing rate by electing to use a risk-free rate as the discount rate for all leases.[118] The amendments allow lessees that are not public business entities to make the risk-free rate election by asset class rather than for all leases. The amendments also clarify that such lessees should use the rate implicit in the lease when it is readily determinable, rather than the incremental borrowing rate or the risk-free rate.[119]

The updated guidance is intended to address concerns that some private company stakeholders[120] may be reluctant to make the risk-free rate election for all leases because doing so "would result in recognizing lease liabilities and right-of-use assets that are greater than those recognized using the lessee's incremental borrowing rate or the rate implicit in the lease (if that rate is readily determinable)."[121] Stakeholders also noted that the election could cause some leases that otherwise would be classified as operating leases to be classified as financing leases.[122] By providing non-public business entities with the flexibility to elect the practical expedient for individual asset classes rather than the entity as a whole, the Board expects more of those entities will make the election.

ASC 842 becomes effective for non-public business entities (and not-for-profit entities that are not conduit bond issuers) for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.[123] However, some of those entities have already adopted ASC 842 because early application is permitted.[124] Entities that have not yet adopted ASC 842 as of November 11, 2021 (the date ASU 2021-09 was issued) will be

---

114. ASC 842, *supra* note 72 (para. 842-20-30-3).
115. *Id.*; *see also* ASU 2021-09, *supra* note 112, at 1.
116. ASU 2021-09, *supra* note 112, at 12 (BC5).
117. ASC 842, *supra* note 72 (para. 842-20-30-3).
118. *Id.*
119. *Id.*; *see also* ASU 2021-09, *supra* note 112, at 2.
120. ASU 2021-09, *supra* note 112, at 1. As part of its post-implementation review of ASC 842, the Board hosted two public roundtable sessions in September 2020 to solicit feedback from a cross-section of stakeholder groups, including private company stakeholders. This issue was identified during those sessions. *Id.*
121. *Id.* at 12–13 (BC8).
122. *Id.*
123. ASC 842, *supra* note 72 (para. 842-10-65-1).
124. ASU 2021-09, *supra* note 112, at 2.

required to apply the amendments at the same time as they adopt ASC 842.[125] Those entities should apply the existing transition provisions in ASC 842.[126] For entities that have adopted ASC 842 as of November 11, 2021, the amendments will be effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.[127] Those entities should apply the amendments on a modified retrospective basis to leases that exist at the beginning of the fiscal year of adoption. Earlier application is permitted.[128]

8. Disclosures by Business Entities About Government Assistance

In November 2021, the FASB issued ASU No. 2021-10[129] to improve transparency in the reporting of government assistance by requiring companies to disclose, in the notes to their financial statements, information about certain types of government assistance that they receive. ASU 2021-10 adds new Topic 832, Government Assistance,[130] to the Codification to provide guidance on the disclosure of certain government assistance received by an entity. The objective of these disclosures is to provide information that enables an investor or other financial statement user to better understand the nature of the transactions, the related accounting policies, and the effect of the transactions on the entity's financial statements, as well as the significant terms and conditions of the transactions.[131] ASC 832 provides guidance on disclosures for transactions with a government that are accounted for by applying a grant or contribution accounting model by analogy.[132]

Under ASC 832, an entity is required to disclose for annual periods the following information about transactions with a government:

1. The nature of the transactions, including a general description of the transactions and the form in which the assistance has been received (for example, cash or other assets);

2. The accounting policies used to account for the transactions; and

3. The line items on the balance sheet and income statement that are affected by the transactions and the amounts applicable to each financial statement line item in the current reporting period.[133]

125. ASC 842, *supra* note 72 (para. 842-10-65-6).
126. *Id.*
127. *Id.*
128. *Id.*
129. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-10, Government Assistance (Topic 832) (Nov. 2021) [hereinafter ASU 2021-10].
130. *Accounting Standards Codification 832, Government Assistance*, Fin. Acct. Standards Bd., https://asc.fasb.org/subtopic&trid=128342807 (last visited Mar. 15, 2022) [hereinafter ASC 832].
131. *Id.* (para. 832-10-50-2).
132. *Id.* (para. 832-10-05-2, -15-4).
133. *Id.* (para. 832-10-50-3).

The new guidance is intended to addresses diversity in practice that exists under current GAAP, which previously did not include specific guidance on the recognition, measurement, and disclosure of government assistance.[134] Although the new guidance is limited to disclosure, the FASB noted that disclosure could shed light on other issues related to recognition, measurement, and presentation that might inform broader standard setting in the future.[135] As initially proposed, the amendments would have applied to a broader scope of arrangements; however, the Board decided to narrow the types of arrangements subject to the new disclosure requirements, in part to ensure timely issuance of the amendments in light of the significant increase in government funding provided in response to the COVID-19 pandemic.[136]

The amendments apply to all entities other than certain not-for-profit entities and certain employee benefit plans.[137] The amendments are effective for financial statements issued for annual periods beginning after December 15, 2021, and early application is permitted.[138] Entities may apply the guidance either (1) prospectively to transactions that are reflected in the financial statements at the date of initial application and to new transactions entered into after that date, or (2) retrospectively.[139]

B. ASU Originated by the EITF

Earnings Per Share, Debt—Modifications and Extinguishments, Compensation—Stock Compensation, and Derivatives and Hedging—Contracts in Entity's Own Equity

In May 2021, in response to a consensus of the EITF, the FASB issued ASU No. 2021-04,[140] to clarify accounting for modifications or exchanges of freestanding equity-classified written call options (such as warrants) that remain equity classified after the modification or exchange.[141] The update amends ASC Topic 815, Derivatives and Hedging[142] and related Topics within the Codification to address stakeholder concerns about "diversity in an issuer's accounting for economically similar modifications or exchanges of freestanding equity-classified written call options" by providing explicit guidance for certain financial instruments that are not covered by another Topic.[143]

---

134. ASU 2021-10, *supra* note 129, at 8 (BC2).

135. *Id.* at 8 (BC4).

136. *Id.* at 9 (BC6).

137. ASC 832, *supra* note 130 (para. 832-10-15-2).

138. *Id.* (para. 832-10-65-1).

139. *Id.*

140. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-04, Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40) (May 2021) [hereinafter ASU 2021-04].

141. *Id.* at 1, 18 (BC2).

142. *Accounting Standards Codification 815, Derivatives and Hedging*, Fin. Acct. Standards Bd., https://asc.fasb.org/topic&trid=2229140 (last visited Mar. 15, 2022) [hereinafter ASC 815].

143. ASU 2021-04, *supra* note 140, at 18 (BC3).

The amendments apply to modifications of free-standing equity classified written call options that remain equity classified after modification and clarify that such modifications should be treated as an exchange of the original instrument for a new instrument, regardless of whether the modification is executed through an amendment to an existing instrument or replacement of an existing instrument with a new instrument.[144] The new guidance also addresses how an entity should measure the effect of such modification or exchange. If the modification or exchange relates to an existing debt instrument, an entity should measure the effect as the difference between the fair value of the modified or exchanged written call option and the fair value of that written call option immediately before it is modified or exchanged.[145] For all other modifications or exchanges, entities should measure the effect as the excess, if any, of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before it is modified or exchanged.[146]

The amendments further clarify that entities should recognize modifications or exchanges in the same manner as if cash were paid instead of modifying or exchanging the instruments, and provides specific guidance as follows:[147]

1. For a financing transaction to raise equity, the effect should be recognized as an equity issuance cost;
2. For a financing transaction to raise or modify debt, the effect should be recognized as a cost in accordance with the guidance on debt and interest;
3. For other modifications that are not related to financings or compensation for goods or services[148] or other exchange transactions addressed by other Topics in the Codification, the effect should be recognized as a dividend.

Additionally, for an entity that presents earnings per share ("EPS") in accordance with ASC Topic 260, Earnings Per Share,[149] that dividend should be an adjustment to net income (or net loss) in the basic EPS calculation.[150]

The amendments in ASU 2021-04 are effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years, and should be applied prospectively to modifications occurring on or after the effective date.[151] Early adoption is permitted.[152]

144. ASC 815, *supra* note 142 (para. 815-40-35-16).

145. *Id.*

146. *Id.*

147. *Id.* (para. 815-40-35-17); *see also* ASU 2021-04, *supra* note 140, at 2.

148. *Accounting Standards Codification 718, Compensation—Stock Compensation*, Fin. Acct. Standards Bd., https://asc.fasb.org/topic&trid=2228938 (last visited Mar. 15, 2022) [hereinafter ASC 718].

149. *Accounting Standards Codification 260, Earnings Per Share*, Fin. Acct. Standards Bd., https://asc.fasb.org/topic&trid=2144383, (last visited Mar. 15, 2022).

150. ASC 815, *supra* note 142 (para. 815-40-35-17(d)); *see also* ASU 2021-04, *supra* note 140, at 3.

151. ASC 815, *supra* note 142 (para. 815-40-65-2).

152. *Id.*

C. ASU Originated by the PCC

Stock Compensation

In October 2021, in response to a consensus of the PCC, the FASB issued ASU No. 2021-07,[153] which updates ASC Topic 718, Compensation—Stock Compensation,[154] to provide a practical expedient that nonpublic entities may apply to determine the current price of an underlying share for certain share-based awards. The practical expedient allows nonpublic entities to use a value determined by the "reasonable application of a reasonable valuation method" as the current price input for purposes of determining fair value of awards classified as equity.[155] The Board and the PCC expect the amendments to reduce the cost and complexity of determining the current price input into an option pricing model while continuing to provide decision-useful information.[156]

ASC 718 provides guidance on accounting for share-based compensation awards. Under this guidance, share-based awards, such as share-option awards, are initially measured at grant date fair value and are not subsequently re-measured unless they are modified and meet certain requirements.[157] Because they generally do not have observable market prices for their equity shares, nonpublic entities must estimate grant date fair value and typically use an option pricing model to do so.[158] One of the inputs for estimating fair value under a common option pricing model is current share price. Private company stakeholders have indicated that estimating current share price can be costly and complex.[159]

The practical expedient issued in ASU 2021-07 is intended to address stakeholder concerns about the cost and complexity of estimating current share price for purposes of estimating fair value. The practical expedient allows a nonpublic entity to determine the current price of a share underlying an equity-classified share-based award using the "reasonable application of a reasonable valuation method."[160] The amendments describe the characteristics of this valuation method, which are the same as those used in regulations of the U.S. Department of the Treasury under Section 409A[161] of the U.S. Internal Revenue Code (the "Treasury Regulations").[162] A valuation performed in accordance with the applicable Treasury Regulations, which has the characteristics described in the practical expedient, is an example of a valuation that is reasonable for purposes of the practical expedient.[163] The

153. Fin. Acct. Standards Bd., Accounting Standards Update No. 2021-07, Compensation—Stock Compensation (Topic 718) (Oct. 2021) [hereinafter ASU 2021-07].

154. ASC 718, *supra* note 148.

155. *Id.* (para. 718-10-30-20C).

156. ASU 2021-07, *supra* note 153, at 17 (BC32).

157. ASC 718, *supra* note 148; *see also* ASU 2021-07, *supra* note 153, at 10.

158. ASU 2021-07, *supra* note 153, at 10.

159. *Id.* at 10–11.

160. ASC 718, *supra* note 148 (para. 718-10-30-20C).

161. 26 U.S.C. § 409A (2018).

162. 26 C.F.R. § 1.409A-1(b)(5)(iv)(B) (2021). Section 409A and the applicable Treasury Regulations govern taxation of nonqualified deferred compensation and apply to many share-based compensation arrangements.

163. ASC 718, *supra* note 148 (para. 718-10-30-20G).

PCC noted that, for income tax purposes, nonpublic entities may already be using methodologies that are presumed to result in reasonable valuations of share-based equity awards under the Treasury Regulations, and that same valuation could be used to achieve the practical expedient.[164]

The amendments in ASU 2021-07 are effective on a prospective basis for all qualifying awards granted or modified during fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application is permitted for financial statements that have not been issued or made available for issuance as of October 25, 2021 (the date ASU 2021-07 was issued).[165] The practical expedient is available only to nonpublic entities and does not apply to awards that are classified as liabilities.[166]

164. ASU 2021-07, *supra* note 153, at 3, 10 (BC5).
165. ASC 718, *supra* note 148 (para. 718-10-65-16).
166. *Id.* (para. 718-10-30-20C).

Caselaw Developments 2021*

Overview

Supreme Court. The Supreme Court held that, in rebutting the fraud-on-the-market ("FOTM") presumption when opposing a class certification motion, defendants (i) may argue that alleged misstatements that are general in nature are less likely to affect price than more specific statements but (ii) must carry the burden of proving that the alleged misstatements did not affect the relevant security's price by a preponderance of the evidence.[1]

Materiality. The Second Circuit held that alleged misstatements were not material because they were stale since, for example, the plaintiffs bought the defendant bank's securities some four years after the bank's supposed misrepresentation that an impairment charge for its Estonian branch was a technical accounting exercise that would not affect long-term strategy and, during those four years, the bank had admitted that its anti-money laundering ("AML") processes at the branch were insufficient, the press had reported the bank was involved in a multibillion dollar money-laundering scandal, and multiple regulators had publicized investigations of the bank.[2] Where plaintiffs alleged the issuer misled investors about deteriorating relations with business counterparties, the Second Circuit found some statements—such as the company was "pretty confident" of renewing contracts—inactionable puffery but held the CEO's representation that the issuer was "not getting any pushback" sufficiently "concrete" to be material.[3] The Ninth Circuit held that statements in Alphabet's 10-Qs that there had been no material changes in the risk factors the company identified in its 10-K (some of which concerned the possibility of security breaches) were plausibly material where Google discovered—after the 10-K was filed but before the 10-Qs were filed—a three-year-long security breach possibly affecting the information of hundreds of thousands of users.[4]

Falsity. The Second Circuit reversed a dismissal, holding that a statement could be false for Rule 10b-5(b) liability even though the statement concerned

* The caselaw developments cover opinions decided in 2021. Where this portion of the annual review expresses opinions, they are those of the author of the caselaw developments, William O. Fisher, and not necessarily the opinions of other authors contributing to the annual review, or of members of the subcommittee producing the review, or of the American Bar Association.

1. *See infra* notes 23–39 and accompanying text.
2. *See infra* notes 43–59 and accompanying text.
3. *See infra* notes 60–85 and accompanying text.
4. *See infra* notes 86–114 and accompanying text.

actions that would not be fraudulent under Rule 10b-5(a) or (c).[5] That same circuit reversed a dismissal where the complaint plausibly pled that statements could be interpreted by a reasonable investor in a way that would make the statements false.[6]

Forward-looking statements. The Ninth Circuit affirmed dismissal of a Rule 10b-5 complaint against Tesla based on statements reporting progress toward producing 5,000 Model 3 vehicles per week by the end of 2017, holding representations that the company was "on track" to realize that goal were simply ways of expressing a management objective and, accordingly, protected by the statutory safe harbor for forward-looking statements.[7]

Scienter and scienter pleading. The Ninth Circuit held scienter pleading wanting where an investment bank published a target for a stock higher than the price of an offering of that very stock—about twenty-four hours later—in which the investment bank participated.[8] The Fourth Circuit held scienter pleading inadequate where it rested significantly on after-the-fact admissions by executives that the defendant issuer had pursued a poor business strategy during the period of the alleged fraud.[9] The First Circuit reversed dismissal and held that a complaint pled a strong inference of scienter in a case involving the introduction of a product that allegedly did not work on the theory that, if the top executives touting the product had inquired within their company before making their complimentary statements, they would have known that the product was inoperable and therefore would have intended their statements to deceive; and if, alternatively, the executives had not inquired, their statements were reckless in a Rule 10b-5 sense.[10]

Application of the *Affiliated Ute* presumption. In reversing denial of summary judgment for defendants where plaintiffs pled that Volkswagen had violated Rule 10b-5 by statements about environmental commitment and compliance during the time the company was installing devices on diesel vehicles to defeat emissions tests, the Ninth Circuit declined to apply the *Affiliated Ute* reliance presumption, finding the omissions claimed in the action to be the inverse of the affirmative misrepresentations on which the plaintiff pled it relied.[11]

Life sciences. The First Circuit affirmed judgment for the Securities and Exchange Commission ("SEC" or "Commission") against a CEO who stated that his company had had no "formal discussions" with the Food and Drug Administration ("FDA") concerning "further trials" for a drug but evidence showed that the FDA had recommended a second Phase 3 trial in a pre-New Drug Application ("NDA") meeting documented by minutes jointly prepared with input from both the FDA and the CEO's company.[12] That same court found no Rule

5. *See infra* notes 117–31 and accompanying text.
6. *See infra* notes 132–47 and accompanying text.
7. *See infra* notes 148–92 and accompanying text.
8. *See infra* notes 200–26 and accompanying text.
9. *See infra* notes 227–52 and accompanying text.
10. *See infra* notes 253–77 and accompanying text.
11. *See infra* notes 278–98 and accompanying text.
12. *See infra* notes 301–41 and accompanying text.

10b-5 claim where a complaint alleged that defendants misleadingly understated the risks of a drug company's reliance on a single manufacturer to produce its finished pill but where that company had disclosed that it depended on a single source, and where that single source had overcome production problems before the particular problem that eventually led to an interruption in supplying pills to customers.[13]

Insider trading. The Second Circuit affirmed the conviction of a tipper who transmitted information about a merger and who the government pursued on the misappropriation theory.[14] That same circuit applied the theory developed in its 2009 *Dorozhko* decision to affirm the conviction of a defendant who participated in a conspiracy to steal press releases from wire services before the services published those releases and the hackers in the conspiracy used stolen wire service employee credentials to enter the services' computer systems.[15]

Manipulation. The Second Circuit reversed dismissal of a Rule 10b-5 manipulation claim against an investment bank that sold a derivative product, the value of which was inversely related to volatility as measured by the S&P 500 VIX Short-Term Futures Index ("VIX Futures Index"), where the bank had a practice—when market volatility spiked—of hedging its exposure to losses on the notes by buying VIX futures in such large amounts that those purchases drove up the price of the VIX Futures Index and in turn drove down the value of the notes.[16]

Proxy statements. The Seventh Circuit affirmed dismissal of a section 14(a) claim where the plaintiffs argued that the proxy statement wrongly omitted the unlevered cash flow numbers underlying an investment banker cash flow analysis that the proxy statement included.[17] The Second Circuit reversed dismissal of a Rule 10b-5 claim where the complaint plausibly alleged that, at the time of the proxy solicitation, the buyer group had a plan to relist the company after the going-private merger but stated in the solicitation only that they might develop such a plan after the merger took place.[18] The Ninth Circuit applied to challenged opinions in a section 14(a) case the analysis that the Supreme Court developed in its 2015 *Omnicare* decision setting out how an opinion might be false or misleading for purposes of Securities Act of 1933 ("Securities Act") section 11 liability.[19]

SEC procedure. The Fifth Circuit held that a respondent in an ongoing administrative proceeding could sue in federal court to enjoin that proceeding on the structural constitutional ground that the Administrative Law Judge ("ALJ") presiding was unconstitutionally protected from removal by the executive branch.[20] The Second Circuit held that the statute of limitations for civil

13. *See infra* notes 342–68 and accompanying text.
14. *See infra* notes 371–98 and accompanying text.
15. *See infra* notes 399–405 and accompanying text.
16. *See infra* notes 406–45 and accompanying text.
17. *See infra* notes 451–86 and accompanying text.
18. *See infra* notes 487–502 and accompanying text.
19. *See infra* notes 503–11 and accompanying text.
20. *See infra* notes 514–28 and accompanying text.

penalties could be tolled by agreement and that a district court did not abuse its discretion in determining the number of violations used to compute the cap on such penalties by counting the number of fraud victims.[21]

Criminal cases. The Third Circuit reversed convictions based on allegedly false reporting of past due loans where the reporting requirements were ambiguous, and the government had failed to prove that the reports were false under all reasonable interpretations of those requirements.[22]

Supreme Court

Rebutting the FOTM presumption. The Court held in *Basic Inc. v. Levinson* that a plaintiff may prove reliance,[23] which is an essential element of a private Rule 10b-5 action,[24] by showing that the relevant security traded in an efficient market and invoking the FOTM presumption that the price at which the plaintiff bought or sold incorporated the false information conveyed by the fraud so that the plaintiff indirectly relied on the fraud by buying or selling at that price, even if the plaintiff never personally heard or read the fraud.[25] Among other things, the FOTM presumption permits securities plaintiffs to certify a class under Federal Rule of Civil Procedure 23(b)(3), which can only be invoked if the plaintiff can show that "the questions of law or fact common to class members predominate over any questions affecting only individual members."[26] Without the presumption, the need to prove that each class member heard or read the asserted fraud would preclude such a "common questions predominate" finding.[27]

The Court held in *Halliburton Co. v. Erica P. John Fund, Inc.* ("*Halliburton II*") that the plaintiff invoking the presumption on a class certification motion need only show that the market in which the relevant security traded was generally efficient in the sense that it generally incorporated new information into the security's price.[28] After that showing, a defendant can still prevent application of the FOTM presumption by presenting evidence that the *particular* statement comprising the asserted fraud did not impact that price.[29]

In 2021, the Court addressed both (i) what kind of evidence a defendant may present to show that the fraud had no price impact and thereby rebut the presumption and (ii) the burden of proof that a defendant must shoulder in that rebuttal.

21. *See infra* notes 529–48 and accompanying text.
22. *See infra* notes 549–84 and accompanying text.
23. 485 U.S. 224, 243–47 (1988).
24. Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 263 (2014) [hereinafter *Halliburton II*].
25. *Id.* at 268.
26. Fed. R. Civ. P. 23(b)(3).
27. Goldman Sachs Grp., Inc. v. Ark. Tchr. Ret. Sys., 141 S. Ct. 1951, 1959 (2021) [hereinafter *Goldman*].
28. *Halliburton II*, 573 U.S. at 279.
29. *Id.*

Turning to the first question, the plaintiffs contended (i) that generic statements by Goldman Sachs—for example, that it had "extensive procedures and controls that are designed to identify and address conflicts of interest"—(a) were false or misleading because the investment bank had "undisclosed conflicts of interest" and (b) "maintained an artificially inflated stock price" for Goldman stock and (ii) that "once the truth about [the firm's] conflicts came out, Goldman's stock price dropped and shareholders suffered losses."[30] The Court read the record to mean that both the plaintiffs and Goldman agreed that "the generic nature of an alleged misrepresentation often will be important evidence of price impact because, as a rule of thumb, 'a more-general statement will affect a security's price less than a more-specific statement on the same question.'"[31] Since a majority of the Justices found that the Second Circuit's opinion in the case left them in doubt as to whether the court of appeals had "properly considered the generic nature of Goldman's alleged misrepresentations," the Court remanded the case to the lower appellate court for further proceedings in light of the clear guidance that the generality of the representations was relevant to whether they impacted the price.[32]

Moving to the second question, the majority opinion held that a defendant seeking to rebut the application of the FOTM presumption by presenting evidence that the alleged fraud had no price impact cannot prevent the presumption's application simply by shouldering a burden of production and offering "*some* evidence" that the challenged statements had no impact or "'evidence that, if believed, would support a finding' of a lack of price impact."[33] Instead, the defendant "bears the burden of persuasion to prove a lack of price impact" and "must carry that burden by a preponderance of the evidence."[34]

Goldman argued that Evidence Rule 301 should govern the quantum of proof required.[35] That rule provides: "In a civil case, unless a federal statute or these rules provide otherwise, the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption. But this rule does not shift the burden of persuasion, which remains on the party who had it originally."[36] The majority of Justices, however, held that (i) the Court had the power to change this rule-mandated result and (ii) had already done so (a) by writing in *Basic Inc. v. Levinson* that a defendant could avoid the FOTM presumption by a "'*showing* that *severs the link* between the alleged misrepresentation and . . . the price'" and (b) by writing in *Halliburton II* that a defendant could rebut the presumption at the class certification stage "'by *showing* . . .

30. *Goldman*, 141 S. Ct. at 1957.
31. *Id.* at 1960.
32. *Id.* at 1961, 1963.
33. *Goldman*, 141 S. Ct. at 1962 (emphasis by the Court) (majority opinion quoting from concurring and dissenting opinion of Justice Gorsuch).
34. *Id.* at 1963.
35. *Id.* at 1961–62.
36. *Id.* at 1962 (quoting Fed. R. Evid. 301).

that the particular misrepresentation at issue did not affect the stock's market price.'"[37]

Significance and analysis. First, while the Court decided *Goldman* in the context of a class certification motion, its ruling will almost certainly be extended to trials. Thus, in a securities class action trial, after a plaintiff relying on the FOTM presumption proves the general efficiency of the market in which the relevant security traded, the defendant contesting that presumption on the ground that the alleged fraud had no impact on the price of that security will have the burden of proving that there was no such price impact.

Second, even though the *Goldman* plaintiffs proceeded on a price maintenance theory—i.e., that the allegedly false statements "maintained an artificially inflated stock price"[38] rather than that those statements caused such inflation in the first place—the Court expressly declined to endorse that theory.[39] When combined with the rule that a defendant seeking to avoid application of the FOTM presumption carries the burden of proving a negative—that the statements did not "maintain" the price—this theory makes effective attack on the presumption extremely difficult in price maintenance cases. Indeed, the very evidence that shows that the statements had no price impact because they were not contemporaneously associated with statistically significant movement in the security's price cannot, by definition, *disprove* price maintenance.

Third, while *Goldman* affects rebuttal of the FOTM presumption, it does not disturb the requirement that, in order to successfully invoke the presumption at all, the plaintiff must show that the market for the applicable security was, in general, informationally efficient.

Courts of Appeal

Materiality. In large part the securities laws determine whether a fact must be disclosed or whether a misstatement is actionable by analyzing the materiality of the omission or statement. In 2021, the Second Circuit affirmed dismissal where many of the alleged misrepresentations were stale because no reasonable investor

---

37. *Id.* (emphasis added by the Court in *Goldman*) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988); *Halliburton II*, *supra* note 24, 573 U.S. at 279).

The majority consisted of five justices. Justice Sotomayor concurred as to both legal questions set out above but dissented on sending the case back to the appellate court because she concluded that "the Second Circuit 'properly considered the generic nature of Goldman's alleged misrepresentations.'" *Id.* at 1964 (Sotomayor, J., concurring and dissenting). Justice Gorsuch, joined by Justices Thomas and Alito, concurred as to the first legal issue above but dissented as to the second, arguing that "nothing in our prior decisions has ever placed a burden of persuasion on the defendant with respect to any aspect of the plaintiff's case." *Id.* at 1969 (Gorsuch, J., concurring and dissenting).

On remand, the Second Circuit sent the case back to the district court. Ark. Tchr. Ret. Sys. v. Goldman Sachs Grp., Inc., 11 F.4th 138, 143 (2d Cir. 2021). The district court then ruled in favor of the plaintiffs because "review of all evidence probative of price impact reveals that the alleged misstatements had *some* impact on the price of Goldman's stock during the Class Period." *In re* Goldman Sachs Grp., Inc. Sec. Litig., Master File No. 10 Civ. 3461 (PAC), 2021 WL 5826285, at *15 (S.D.N.Y. Dec. 8, 2021).

38. *Goldman*, 141 S. Ct. at 1957 (majority opinion).

39. *Id.* at 1959 n.1.

would have found those statements material at the time the plaintiffs purchased their securities in light of the publicity—after the statements but before the plaintiffs bought—surrounding the defendant bank's extensive money-laundering problems.[40] That circuit also drew the line between puffery and material statements, affirming dismissal of a Rule 10b-5 action against a credit card issuer as to all alleged misstatements about contract renewals for issuance of retailer-branded cards—except as to the specific remark that the defendant was not experiencing "any pushback" from the retailers after the defendant raised its credit standards for issuing cards.[41] The Ninth Circuit reversed dismissal of a Rule 10b-5 action against Google's publicly traded parent based on its statements in two Form 10-Qs that there had been no material change in its risk factors described in its Form 10-K, where the risk factors in the 10-K included security breaches but the company discovered, but not disclosed—after filing the 10-K but before filing the 10-Qs—a security breach that had persisted for three years and potentially compromised the private information of hundreds of thousands of Google users.[42]

<u>The immateriality of stale representations</u>. The plaintiffs in *Plumber & Steamfitters Local 773 Pension Fund v. Danske Bank A/S* brought a Rule 10b-5 claim against a bank and its officers premised on alleged misstatements as the bank uncovered and publicized its AML problems at the Estonian branch that it had acquired in 2006.[43] The Second Circuit affirmed dismissal because it found some statements immaterial, others not misleading, and that one of the statements was made after the plaintiffs bought.[44]

Statements in the bank's Corporate Responsibility Reports for 2013 and 2014—e.g., that the bank "'condemns . . . money laundering,' 'takes the steps necessary to comply with internationally recogni[z]ed standards, including Know Your Customer procedures,' and has procedures for 'customer due diligence, reporting, . . . and communications'"—were "'[g]eneral declarations about the importance of acting lawfully and with integrity[,]' [which constituted] inactionable puffery."[45] And, since such statements "averred that [the bank] took steps to comply with AML protocols and vaguely recited some AML buzzwords [but] claimed no particular acts of compliance[, n]o reasonable investor . . . would weigh these generic statements in its investment calculus."[46] Accordingly, these statements were simply immaterial by their very nature.[47]

While the plaintiffs contended that the bank's financial statements were deceptive because they included "allegedly ill-gotten profits" and were released "without simultaneously disclosing what [the bank] knew about possible money laundering at [its Estonian] branch," the Second Circuit held no claim could be based on the

40. *See infra* notes 43–59 and accompanying text.
41. *See infra* notes 60–85 and accompanying text.
42. *See infra* notes 86–114 and accompanying text.
43. 11 F.4th 90, 95, 96, 98 (2d Cir. 2021).
44. *Id.* at 95–96, 106.
45. *Id.* at 103 (quoting ECA & Loc. 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 206 (2d Cir. 2009)).
46. *Id.* at 104.
47. *Id.* at 103–04.

financials both because (i) the plaintiffs did "not allege that the financial numbers Danske disclosed were manipulated in any way" and (ii) a company has no obligation, simply by publishing its financial reports, to disclose wrongdoing that might have been aggregated into the numbers in those reports.[48] To the plaintiffs' response that the financial numbers misled because they included profits from legally unenforceable agreements for bank accounts that had been used for money laundering, the court of appeals responded that the plaintiffs "identif[ied] no law or contractual provision that would render the deposit contracts unenforceable" under whatever "foreign contract law" would apply.[49] The plaintiffs therefore did not allege the financial statements to be misleading.[50]

The plaintiffs bought the bank's American Depository Receipts ("ADRs") in between March and June 2018.[51] The appellate court observed that "[o]ld information tends to become less salient to a prospective purchaser as the market is influenced by new information that is related or of overriding impact."[52] Accordingly, the bank's disclosure of goodwill impairment in 2014—and the accompanying statement of its CFO that this was "'primarily a technical accounting exercise'" that was "'not related to expected short-term performance of the affected business areas,' and . . . '[would] not affect Danske Bank's ongoing business or the strategy for the involved units'"—would not support a Rule 10b-5 claim "[e]ven if the [plaintiffs] could show that the planned . . . closure [of the accounts involved in the money laundering] prompted the write-down."[53] Between the disclosure of the impairment and the CFO's public interpretation of it, on the one hand, and the plaintiffs' securities purchases, on the other hand, (i) the bank had in March 2017 "admitted that AML processes at its Estonian Branch were 'insufficient to ensure that we could not be used for money laundering'"; (ii) the bank had in September 2017 issued a press release saying "that 'several major deficiencies' rendered the Bank unable to prevent money laundering 'in the period from 2007 to 2015'"; (iii) roughly at the same time, "a Danish newspaper reported that [the bank] was enmeshed in a 'gigantic money-laundering scandal' involving more than DKK 7 billion"; and (iv) Danish, French, and Estonian regulators publicized investigations into the bank, with the Danish regulator having imposed a fine on the bank.[54] As a result, *by the time the plaintiffs bought their ADRs*, the impairment and accompanying comments no longer passed the materiality test: "it [was] implausible that the fine points of a technical accounting exercise conducted back in 2014 'significantly altered the total mix of information' available to the Funds in 2018."[55]

48. *Id.* at 98–99.
49. *Id.* at 99.
50. *Id.* at 98–100.
51. *Id.* at 98.
52. *Id.* at 101.
53. *Id.* at 100.
54. *Id.* at 101.
55. *Id.* (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). But the court added this caveat: "Obviously, not all statements become immaterial after a similar or set length of time. Whether the influence of a misstatement or omission survives will depend on its nature and

The Second Circuit employed the same reasoning to conclude that the 10b-5 claim could not rest on a statement in the 2015 Corporate Responsibility Report that in 2014 "three cases were reported in the whistleblower system. All the cases were concluded, and the appropriate actions were implemented."[56] "Even assuming that this statement was misleading by omission" because it failed to mention what became an important whistleblower complaint that a bank-initiated investigation found to have been improperly handled, "[t]he Bank issued this statement in 2015, three years before the Funds purchased any ADRs" and "intervening events made it such that no 'reasonable' investor contemplating purchasing Danske ADRs in 2018 'would consider it important in deciding how to act.'"[57]

Finally, the Second Circuit held that the plaintiffs had no Rule 10b-5 claim based on a footnote to 2018 financial statements saying that the bank did not expect "'the outcomes of pending lawsuits and disputes, the dialogue with public authorities or the inspection of compliance with anti[-]mon[e]y laundering legislation to have any material effect on its financial position.'"[58] Since the bank published the financials including that statement *after* the plaintiffs bought their ADRs, it "could not have influenced the price of a purchase that had already been made."[59]

<u>The line between puffery and actionable statements</u>. A misstated fact, or a fact that a defendant has a duty to disclose but omits, is material for securities law purposes in the buy/sell context only if there is "'a substantial likelihood that the disclosure of the omitted fact [or the truth about the falsehood] would have been viewed by the reasonable investor as having significantly altered the "total mix" of information . . . available'" at the time of the investor's decision.[60] Among other things, this means that general self-congratulatory statements by management are not material because no reasonable investor would likely attribute importance to them when deciding whether to acquire or dispose of the securities issued by the company whose officers or other representatives spout such puffery.[61] *In re Synchrony Financial Securities Litigation* required the Second Circuit to draw the line between material misstatement and puffery in the

the intervening load of information on the subject, and on other developments affecting the market and the enterprise." *Id.* at 102.

56. *Id.* at 102.

57. *Id.* at 103 (quoting ECA & Loc. 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 197 (2d Cir. 2009)).

58. *Id.* at 104 (alteration in original).

59. *Id.* at 104–05. The court also concluded the plaintiffs had not alleged a Rule 10b-5 claim under that rule's subsections (*a*) and (*c*). *Id.* at 105. Such a claim—like a claim for misstatements and omissions under Rule 10b-5(b)—must satisfy a "heightened pleading standard." *Id.* The complaint failed that standard because it did not "articulate with precision the contours of an alleged scheme to defraud investors, or which specific acts were conducted in furtherance of it." *Id.*

60. Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

61. *See*, *e.g.*, IBEW Loc. Union No. 58 Pension Tr. Fund & Annuity Fund v. Royal Bank of Scotland Grp., PLC, 783 F.3d 383, 392 (2d Cir. 2015).

context of a deteriorating relationship between a financial services company and retail merchandise partners.[62]

Synchrony Financial ("Synchrony") credit-checked credit card applicants, issued credit cards, and owned the accounts that the cards generated.[63] Synchrony partnered with retailers such as Sam's Club, Amazon, Lowe's, and Walmart by issuing both private label credit cards ("PLCC"), which cardholders could use only at a partner's stores, and general purpose co-brand cards ("Dual Cards"), which cardholders could use both at a partner's stores and at other stores.[64] A partner received some of a cardholder's fees, interest payments, and other charges against the holder's account.[65]

Walmart was one of Synchrony's most important partners.[66] The plaintiff brought a Rule 10b-5 claim against Synchrony and its officers and directors, contending that they committed fraud by statements from October 21, 2016 to November 1, 2018 that were false in light of Synchrony's deteriorating relations with Walmart, which culminated in Walmart suing Synchrony on the last day of the class period.[67] The plaintiff also brought a section 11 claim based on misrepresentations of the same sort in a registration statement for a Synchrony bond offering on December 1, 2017.[68] Plaintiff alleged that Synchrony's conversion of Walmart customers—some of whom were subprime borrowers—from PLCCs to Dual Cards increased Synchrony's credit portfolio losses, a result that moved Synchrony to tighten its credit underwriting standards.[69] Both moves allegedly harmed Walmart. The conversion of the card holders from Walmart-only cards to cards that could be used at any store resulted in Walmart customers shopping elsewhere for some of their retail goods.[70] Tightening credit standards resulted in fewer Synchrony cards being issued to Walmart customers, which reduced the aggregate amount that customers could spend at Walmart.[71]

The Second Circuit affirmed dismissal of the Section 11 claim in its entirety and dismissal of the Rule 10b-5 claim insofar as it was based on all but one of the alleged misrepresentations.[72] The court of appeals held that most of the challenged words constituted inactionable puffery, including (i) "statements that the company was 'pretty confident' and 'pretty positive' about the prospect of renewing partnerships in 2019"; (ii) headings in a 10-K "like 'stable asset quality'

62. 988 F.3d 157 (2d Cir. 2021).
63. *Id.* at 162.
64. *Id.* at 162–63. The decision and this summary use "partner" in a business sense rather than a legal one.
65. *Id.* at 162.
66. *Id.* at 163.
67. *Id.* at 161 (general nature of the fraud); *id.* at 161–62 (class period); *id.* at 164 (Walmart suit); *id.* at 165 (identifying a plaintiff claim as brought under Rule 10b-5).
68. *Id.* at 162, 165, 166, 172–73.
69. *Id.* at 163.
70. *Id.*
71. *Id.*
72. *Id.* at 174. On remand, the district court denied a renewed motion to dismiss the remaining claim. *In re* Synchrony Fin. Sec. Litig., No. 3:18-cv-1818 (VAB), 2022 WL 427499, at *1 (D. Conn. Feb. 11, 2022).

and assertions that Synchrony's 'partner-centric business model has been successful because it aligns [its] interests with those of [its] partners'"[73]; and (iii) "[o]ur business benefits from longstanding and collaborative relationships with our partners, including some of the nation's leading retailers and manufacturers with well-known consumer brands, such as Lowe's, Walmart, Amazon, and Ashley Furniture HomeStore."[74]

The Second Circuit agreed with dismissal as to statements about the "'consistency' in [Synchrony's] underwriting criteria," on the ground that they "did not materially mislead investors, given the context provided by the rest of the disclosures."[75] Here the court concluded not only that naked references to "consistency" did "not provide metrics on which a reasonable investor would rely" but that the company and its executives had also (i) said that Synchrony "was 'always making tweaks and refinements and modifying the model a little bit'"; (ii) disclosed "details of its underwriting practices, including a breakdown of its portfolio composition by FICO score" showing that the percentage of subprime borrowers within Synchrony's loan portfolio decreased between 2008 and 2016; and (iii) commented in June 2016 that loan losses were at historically low levels and that the company expected to see increased net charge-off rates.[76] Thus, "[a] comprehensive reading of Synchrony's public disclosures would reveal to a reasonable investor that Synchrony expected increased loan losses and constantly modified its underwriting model."[77]

The Second Circuit, however, found actionable one statement that was part of the Rule 10b-5 claim but not the section 11 claim: a January 2018 statement by the CEO, in answer to an analyst's question, "that Synchrony's partners were 'very cognizant' of the problem of putting too much credit in the hands of subprime borrowers and, importantly, stated that Synchrony was 'not getting any pushback on credit.'"[78] Instead of being puffery, this "was a 'concrete' description and a 'factual representation' that purported to describe the state of Synchrony's business relationships as of January 19, 2018."[79] And the plaintiff adequately pled "that Synchrony and its representatives knew the statement was false when made, at least with respect to Walmart."[80] One former employee allegedly said that the Synchrony CEO and CFO "traveled to Arkansas with increased frequency during the latter half of 2017 and into early 2018 to mitigate the impact of 'alarming feedback from the Walmart client relationship manager that the relationship was doomed.'"[81] Two articles in the *Wall Street Journal* also "reported that Walmart 'balked' at the idea of renewal in fall 2017 and that, for the first

73. *Id.* at 170, 173.
74. *Id.* at 173.
75. *Id.* at 170.
76. *Id.* at 171.
77. *Id.*
78. *Synchrony Fin.*, 988 F.3d at 168.
79. *Id.* (quoting *In re* IBM Corp. Sec. Litig., 163 F.3d 102, 110 (2d Cir. 1998)) (citation removed from quoted text).
80. *Id.*
81. *Id.*

time in the history of the Walmart–Synchrony relationship, Walmart began soliciting bids from other credit card issuers by late 2017."[82] Other former employees "corroborated this, explaining that it was well known within Synchrony that Walmart had solicited bids from at least one of Synchrony's competitors."[83] Contextual cautions generally disclosing "the competitive nature of the consumer finance market" could not take the misleading bite out of the specific denial that no partner had pushed back on the amount of credit that Synchrony was putting into consumer hands.[84]

Significance and analysis. *Synchrony*'s reasoning on the "consistency" remark—that specific disclosed metrics can sufficiently qualify overbroad general statements so that the general statements do not materially mislead—is correct. As the Supreme Court put it in *Virginia Bankshares*: "While a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil."[85] The power of this contextual defense, however, declines with the specificity of the statement it seeks to qualify.

Materiality of statements about privacy protection. Alphabet, Inc. ("Alphabet"), a publicly traded holding company owning Google LLC, filed a 10-K on February 6, 2018 that disclosed risk factors, including possible breaches of its protocols to protect the privacy of Google users: "If our security measures are breached resulting in the improper use and disclosure of user data . . . our products and services may be perceived as not being secure, users and customers may curtail or stop using our products and services, and we may incur significant legal and financial exposure."[86] The company added that a "breach or unauthorized access . . . could result in significant legal and financial exposure, damage to our reputation, and a loss of confidence in the security of our products and services that could potentially have an adverse effect on our business."[87] In the first two 10-Qs for 2018, the company stated: "There have been no material changes to our risk factors since our Annual Report on Form 10-K . . . ."[88]

Lead plaintiff in a securities action on behalf of all who purchased Alphabet stock from April 23, 2018 through October 7, 2018 alleged that Alphabet and executives violated Rule 10b-5 by the statements in the 10-Qs (as well as other statements) because, the complaint pled, Alphabet discovered in March and April 2018 that a software glitch persisting for three years in Google+ permitted third-party developers to access users' email addresses, birth dates, profile

82. *Id.*

83. *Id.*

84. *Id.* While the court did not rely on it, movement of Synchrony's stock price also supported the materiality of the information about Walmart. The complaint alleged that the price declined by 10 percent after "media sources began reporting Walmart planned to move its PLLC business to Capital One." *Id.* at 164.

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

86. Alphabet, Inc., Annual Report (Form 10-K), at 10–11 (Feb. 6, 2018).

87. *Id.* at 11.

88. Alphabet, Inc., Quarterly Report (Form 10-Q), at 43 (Apr. 24, 2018); Alphabet, Inc., Quarterly Report (Form 10-Q), at 48 (July 24, 2018).

photographs, residences, occupations, and relationship status.[89] After finding that they could not confirm the number of accounts that developers had violated, Google's legal and policy staff advised, in what the complaint called the Privacy Bug Memo, that there were (as the court put it) "additional vulnerabilities."[90] The complaint alleged that the Bug Memo "warned that the disclosure of these security issues 'would likely trigger "immediate regulatory interest" and result in defendants "coming into the spotlight alongside or even instead of Facebook despite having stayed under the radar throughout the Cambridge Analytica scandal,"'" a privacy breach at Facebook that was raging in the media and drawing congressional attention in the spring of 2018.[91] The complaint then alleged that Google deliberately decided against disclosure of its own breach and adopted a plan to close its Google+ platform but that, after an October 8, 2017 *Wall Street Journal* story reported the Google privacy exposure, the company immediately "published a blog post acknowledging the 'significant challenges' regarding data security[, . . .] admit[ting] . . . exposing the private data of hundreds of thousands of users and announc[ing] it was shutting down the Google+ social network."[92] Alphabet's stock price declined on that day and in each of the following two trading days.[93]

Reversing in part the district court's decision dismissing the case in its entirety,[94] the Ninth Circuit held that the complaint adequately alleged that the statements in the two 10-Qs—that there were no material changes in the company's risk factors since the 10-K—were materially false or misleading and that Alphabet, as the maker of those statements, acted with scienter.[95] As put by the panel, "the complaint plausibly alleges that Alphabet's warning in each Form 10-Q of risks that 'could' or 'may' occur [was] misleading to a reasonable investor when Alphabet knew that those risks had materialized."[96]

The complaint alleged that this omission was *materially* misleading because (i) Alphabet's 10-K acknowledged, as the court summarized, "harms that could follow from the detection and disclosure of security vulnerabilities, including public concerns about privacy and regulatory scrutiny";[97] (ii) Google executives had said that user trust in the company's privacy protections were important to Google's

89. *In re* Alphabet, Inc. Sec. Litig., 1 F.4th 687, 695 (9th Cir. 2021), *cert. denied*, 142 S. Ct. 1227 (2022) (mem.); Defs. Not. of Mot. & Mot. to Dismiss Class Action Compl. for Violation of Fed. Sec. Laws & Mem. of Points & Authorities in Support, *In re* Alphabet, Inc. Sec. Litig., 1 F.4th 687 (9th Cir. 2021) (No. 4:18-CV-06245-JSW), 2019 WL 4739971, at *8 (class period).

90. *Alphabet*, 1 F.4th at 696. While neither the appellate nor the district court decisions include the class period, the defense moving papers below do.

91. *Id.*

92. *Id.* at 697.

93. *Id.* The stock closed at $1,167.83 on Friday, October 5, then fell on October 8, 9, and 10, closing on the last date at $1,092.16. *See Historical Data, Alphabet Inc. (GOOGL)*, Yahoo! Fin., https://finance.yahoo.com/quote/GOOGL/history?period1=1538352000&period2=1540166400&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true (last visited Mar. 18, 2022). Thus, between October 5th and 10th, the price fell about 6.5 percent.

94. *Alphabet*, 1 F.4th at 709; *see* text accompanying *infra* note 110.

95. *Alphabet*, 1 F.4th at 703, 705–07.

96. *Id.* at 704.

97. *Id.* at 703.

success;[98] (iii) the market punished Google's stock price when the company confirmed the newspaper story disclosing the three-year privacy exposure;[99] and (iv) SEC guidance had advised that "'[t]he materiality of cybersecurity risks and incidents,'" depends on, among other things, "'harm to a company's reputation, financial performance, and customer and vendor relationships, as well as the possibility of litigation or regulatory investigations or actions, including regulatory actions by state and federal governmental authorities and non-U.S. authorities'"—all of which the complaint alleged had occurred, as predicted by the Privacy Bug Memo.[100] The court found unconvincing the defense reasoning that the omission was immaterial because Google had removed the software glitch before filing the 10-Qs.[101] Not only had the Bug Memo "highlighted additional security vulnerabilities," but "[t]he existence of the software glitch for a three-year period, which exposed the private information of hundreds of thousands of Google+ users, and the fact that Google was unable to determine the scope and impact of the glitch, indicated that there were significant problems with Google's security controls."[102]

Turning to scienter, the appellate court held that "Alphabet is at least one alleged maker of the 10-Q statements here, because Alphabet ha[d] 'ultimate authority over the statement[s,] including [their] content and whether and how to communicate [them].'"[103] Reciting the circuit rule that the "'scienter of the senior controlling officers of a corporation may be attributed to the corporation itself to establish liability as a primary violator of § 10(b) and Rule 10b-5 when those senior officials were acting within the scope of their apparent authority,'" the court then focused on allegations against the Google CEO and the CEO of its holding company, Alphabet.[104] The Ninth Circuit concluded that the complaint pled the scienter of the Google CEO because it alleged that (i) he read the Privacy Bug Memo before Alphabet filed the first of the two 10-Qs that contained actionable language; (ii) that memo described the three-year privacy exposure; (iii) the memo also "warned of the consequences of disclosure, and presented Google leadership with a clear decision on whether to disclose those problems"; and (iv) with this knowledge, the CEO "approved a cover-up to avoid regulatory scrutiny and testimony before Congress" in order "to 'buy time' by avoiding putting Google in the spotlight alongside the Facebook-Cambridge Analytica scandal and at [a] time of heightened public and regulatory scrutiny."[105]

98. *Id.* at 703; *id.* at 695 (Google CEO Pichai "explained in January 2018 [that] 'users use Google because they trust us and it is something easy to lose if you are not good stewards of it. So we work hard to earn the trust every day.'").

99. *Id.* at 703.

100. *Id.* (quoting Commission Statement and Guidance on Public Company Cybersecurity Disclosures, 83 Fed. Reg. 8166, 8168–69 (Feb. 26, 2018)).

101. *Id.* at 704.

102. *Id.*

103. *Id.* at 705 (quoting Janus Cap. Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 142 (2011)).

104. *Id.* at 694 (titles of individuals and organizational detail); *id.* at 705–07 (quoting *In re* ChinaCast Educ. Corp. Sec. Litig., 809 F.3d 471, 476 (9th Cir. 2015) (quoting Adams v. Kinder-Morgan, Inc., 340 F.3d 1083, 1106–07 (10th Cir. 2003))).

105. *Id.* at 706–07.

The court also found allegations raising a strong inference that the Alphabet CEO had scienter.[106] Here the court leaned on its inference that the Alphabet CEO "was vitally concerned with Google's operations," supported by assertions that he (i) was Google's former CEO; (ii) "received weekly reports of Google's operating results"; (iii) "made 'key operating decisions' at Google"; and (iv) was the direct report for Google's CEO at the time the 10-Qs were filed.[107] Perhaps most important, the court reasoned that "[t]he competing inference—that [the Google CEO] concealed 'the largest data-security vulnerability in the history of two Companies whose existence depends on data security' from the CEO of Alphabet at a time when social media networks were under immense regulatory and governmental scrutiny—is not plausible."[108] His "knowledge" could be "imputed to Alphabet."[109]

With misleading omission, materiality, and scienter pled as to the risk factor update language in the two 10-Qs, the Ninth Circuit reversed the dismissal insofar as the plaintiff's case depended on those statements.[110] The court, however, affirmed dismissal of the complaint to the extent it was based on other statements.[111] Boilerplate introductions at the beginning of earnings calls to the effect that some of the material to be presented would constitute forward-looking statements, and that the 10-K identified risks that could frustrate predictions in a material way "did not plausibly give a reasonable investor the 'impression of a state of affairs that differs in a material way from the one that actually exists.'"[112] Statements "emphasiz[ing] Google's and Alphabet's commitment to user privacy, data security, and regulatory compliance" did "not rise to the level of 'concrete description of the past and present'" and therefore "amount[ed] to vague and generalized corporate commitments, aspirations, or puffery that cannot support statement liability under Section 10(b) and Rule 10b-5(b)."[113]

Significance and analysis. *Google* shows that the risk factor disclosures the SEC rules require are two-edged swords. On the one hand, a company can point to them as disclosing a risk that an officer did not mention in a remark during an earnings call or at an investor conference. On the other hand, risk factors can be used by a plaintiff's counsel to argue that a misstatement or omission in those very risk factors is material because it relates to a matter so important that the company alerted investors to it in periodic filings.[114]

106. *Id.* at 706.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.* at 707.
111. *Id.* at 707–09.
112. *Id.* at 708 (quoting Retail Wholesale & Dep't Store Union Loc. 338 Ret. Fund v. Hewlett-Packard Co., 845 F.3d 1268, 1275 (9th Cir. 2017)).
113. *Id.*
114. The risk factor disclosure regulation mandates disclosure of "the *material* factors that make an investment in the registrant or offering speculative or risky." 17 C.F.R. § 229.105(a) (2022) (emphasis added).

Falsity. The Second Circuit held that while a violation of Rule 10b-5(b) requires a false or misleading statement, that statement need not concern underlying facts that would constitute a fraudulent scheme or practice; accordingly, a district court could not automatically dismiss a Rule 10b-5(b) claim simply because the court dismissed in the same case a Rule 10b-5(a) and (c) claim.[115] That circuit also reversed dismissal where the district court interpreted statements about inventory in a way that would not have been false or misleading, holding that the complaint plausibly alleged that a reasonable investor would have interpreted the statements in a different way that would have misled.[116]

False statement under Rule 10b-5(b) versus scheme and practice under Rule 10b-5(a) and (c). In 2021, the Second Circuit considered the different subparts of Rule 10b-5, holding that plaintiffs who failed to allege a scheme to defraud (subpart (a)) or a practice operating as a fraud (subpart (c)), could still allege a fraudulent statement of a material fact (subpart (b)).[117]

Plaintiffs alleged that The Hain Celestial Group, Inc. ("Hain") and named executives violated Rule 10b-5 by falsely attributing growing sales to "'strong consistent consumer demand' and other 'organic' factors," whereas, in fact, they resulted from channel stuffing—"whereby valuable sales concessions were offered to Hain's largest customers as incentives to buy more product than needed before the end of each financial quarter, in order to enable Hain to meet its revenue targets and Wall Street's projections."[118] The district court dismissed the complaint in its entirety.[119] The lower court concluded that the complaint failed to state a fraudulent scheme or course of conduct sufficient for a claim under Rule 10b-5(a) or (c) because "the practice of channel stuffing—increasing sales by offering unsustainable incentives to customers—was not inherently fraudulent."[120] The district court then reasoned that the Rule 10b-5(b) claim "'fail[ed] because its predicate is the illegitimacy of the channel stuffing practices the Court already found to be legitimate.'"[121]

Vacating the defense judgment,[122] the Second Circuit held that subpart "(b) does not require that conduct underlying a purportedly misleading statement or omission amount to a fraudulent scheme or practice."[123] Instead, subpart (b)'s "focus is rather on whether something said was materially misleading."[124] The complaint adequately pled that focus by alleging "that Defendants made statements attributing Hain's high sales volume to strong consumer demand, while omitting to state that increased competition had weakened consumer demand

115. *See infra* notes 117–31 and accompanying text.
116. *See infra* notes 132–47 and accompanying text.
117. *In re* Hain Celestial Grp., Inc. Sec. Litig., 20 F.4th 131 (2d Cir. 2021).
118. *Id.* at 133–34.
119. *Id.* at 135–36.
120. *Id.* at 136.
121. *Id.* at 137 (quoting *In re* Hain Celestial Grp. Inc. Sec. Litig., No. 2:16-cv-04581 (ADS) (SIL), 2020 WL 1676762, at *12 (E.D.N.Y. Apr. 6, 2020) [hereinafter *Hain* Dist. Ct.]).
122. *Id.* at 138. The plaintiffs did not appeal the claims under Rule 10b-5(a) and (c). *Id.* at 136.
123. *Id.* at 137.
124. *Id.* at 136.

and that Hain's high sales volume was achieved in significant part by the offer of unsustainable channel stuffing incentives."[125]

In a second important holding, the Second Circuit found that the district court erred in its analysis of whether the complaint adequately alleged facts raising a strong inference of scienter.[126] The lower court separated its review of this issue into two parts: (i) "circumstantial allegations of scienter, which included, *inter alia*, the Individual Defendants' knowledge of and involvement in the channel stuffing practices; Hain's inadequate internal controls and inaccurate financial reporting; and suspicious terminations, resignations, and demotions of senior employees"; and (ii) "allegations with respect to the Individual Defendants' motive and opportunity to commit fraud, including high-volume insider trading activity by [the Hain CEO] and [the company's EVP for Global Brands, Categories, and New Business Ventures] during the Class Period."[127] Finding that neither, by itself, were sufficient (though the first category "'came quite close' to supporting a strong inference of scienter"), the district court held that this failure, too, justified dismissal.[128]

The Second Circuit ruled that the two sets of allegations should have been assessed together.[129] Declining to undertake that task initially itself, the appellate court ordered that, "[o]n remand, the district court should independently reassess the sufficiency of the scienter allegations, considering the cumulative effect of the circumstantial allegations of intent together with the pleaded facts relating to motive and opportunity."[130]

Significance and analysis. The Second Circuit's analysis of the relationship between the three Rule 10b-5 subparts is correct. Rule 10b-5(b) prohibits, in connection with the purchase or sale of a security, "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."[131] While a defendant must have scienter when making the statement and all the other elements of a 10b-5 claim must be met, the rule does not require that the subject of the misstatement must itself be fraudulent or illegal.

<u>Interpretation of statement about inventory in order to determine whether plaintiffs pled it was false</u>. To determine whether a statement is false, it is sometimes necessary to first determine what the statement means. In *IWA Forest Industry Pension Plan v. Textron Inc.*, the Second Circuit faced this task in the context of reviewing an order granting defendants' motion to dismiss.[132]

125. *Id.* at 137.
126. *Id.*
127. *Id.*
128. *Id.* (quoting *Hain* Dist. Ct., *supra* note 121, 2020 WL 1676762, at *15).
129. *Id.* at 137–38.
130. *Id.* at 138.
131. 17 C.F.R. § 240.10b-5 (2022).
132. 14 F.4th 141 (2d Cir. 2021).

Textron Inc. ("Textron") acquired Arctic Cat Inc. ("Arctic Cat") in early 2017.[133] Arctic Cat produced snowmobiles and off-road dirt vehicles.[134] The Textron CEO acknowledged at the time of the acquisition "that Arctic Cat had 'inventory issues'" because "inventory had 'built up in the [sales] channel,' and the excess inventory that remained from prior model years (model years 2016 and older) was weighing on current sales of new vehicles (model year 2017)."[135] Important to what followed and as indicated in the last sentence, Arctic Cat introduced the vehicles for a new model year in the fall of the preceding year; so that, for example, the 2018 models were introduced in the fall of 2017.[136]

After the CEO's "continued" "discuss[ion of] the status of Arctic Cat's excess aged inventory throughout 2017,"[137] the CEO made three statements about inventory during 2018 earnings calls that investors claimed were false or misleading in a Rule 10b-5 action the investors filed against Textron and the officer.[138] First, in January 2018, the CEO "stated that the company had seen 'improved demand in the snow retail channel, allowing dealers to clear older inventory and drive 2018 model sales.'"[139] Second, in July, he "stated that 'through the course of the year' there had been 'pretty significant reductions in that aged inventory' and that there was 'lower inventory of aged stuff and . . . a lot of exciting new stuff [that] will be on the floors that dealers are pretty excited about.'"[140] He added that the company sold very few Arctic Cat vehicles during the first quarter, which was normal for this seasonal business.[141] Third, in July, the CEO "stat[ed] that, although he did not 'have [the] numbers at [his] fingertips,' 'older inventory ha[d] been moved off [dealers'] books,' dealers were 'taking restockings of current model year product,' and 'last year was great, in terms of burning down a lot of the inventory.'"[142]

The district court dismissed the Rule 10b-5 claims insofar as they rested on these statements, reasoning that the inventory to which they referred was the 2016 model year and older vehicles that Arctic Cat had when Textron bought it and that the complaint did not allege that the 2016 and older inventory had not been reduced.[143] Vacating and remanding the dismissal as it pertained to the three CEO 2018 inventory statements,[144] two members of the panel held that the plaintiff "plausibly alleges a competing interpretation of the[se] statement[s], in which a reasonable investor would have understood [the CEO's] reference to 'older' inventory to include 2017 model year vehicles, as distinguished

133. *Id.* at 143.
134. *Id.*
135. *Id.* (alteration in original) (record citation omitted).
136. *Id.* at 146.
137. *Id.* at 143.
138. *Id.* at 143–44. The investors also sued the CFO. *Id.* at 143.
139. *Id.* at 144.
140. *Id.* (alteration in original) (record citation omitted).
141. *Id.*
142. *Id.* (record citation omitted).
143. *Id.* at 146; *id.* at 149 (Kaplan, J., concurring and dissenting). *See In re* Textron, Inc. Sec. Litig., No. 19cv7881 (DLC), 2020 WL 4059179, at *11 (S.D.N.Y. July 20, 2020).
144. *Textron*, 14 F.4th at 143, 146, 148 (majority opinion).

from the 2018 model year products launched a few months earlier."[145] To this panel majority, a reasonable investor might have understood that the inventory (i) that was being cleared out to "drive 2018 model sales," which was the "exciting new stuff," and (ii) that was resulting in dealers "taking restockings of current model year product," included 2017 models that had been succeeded by the 2018 models in fall 2017 before the CEO's remarks.[146] And the majority held that the complaint adequately alleged that, so interpreted, the CEO's statements were wrong because the plaintiffs alleged "that by the time [the CEO] made the first of these statements during his earnings call in January 2018, non-current model year 2017 inventory had already accumulated at least as fast as 2016 and older inventory was selling."[147]

Forward-looking statements. Beginning on May 3, 2017, Tesla, Inc. ("Tesla") and its CEO Elon Musk made a series of statements about the production of Tesla's new mid-priced sedan (the Model 3), including projections that the company would manufacture 5,000 of these cars per week at some time during that year, as well as statements about the progress of a related factory that was supposed to produce the batteries for the Model 3.[148] After an October 6, 2017 *Wall Street Journal* article reported that Tesla was still in September delivering Model 3s that were built by hand instead of on the automated assembly line that would make the 5,000 per week goal possible, Tesla's stock declined by 3.9 percent,[149] although it quickly recovered.[150] After Tesla announced on November 1, 2017, that it would not meet the 5,000 per week goal, the stock dropped 6.8 percent.[151] Shareholders sued on behalf of all who bought Tesla stock between May 3 and November 1, 2017, claiming that the company, its CEO, and its CFO had violated Rule 10b-5.[152] On appeal of dismissal, the Ninth Circuit affirmed, holding that all the challenged remarks were either forward-looking statements protected by statute or that the complaint did not allege specific facts to show them false.[153]

The statutory protection appears at 15 U.S.C. § 78u-5, which defines "forward-looking statements" to encompass both "the plans and objectives of

145. *Id.* at 146.

146. *Id.* at 144, 146.

147. *Id.* at 147.

The dissenting judge concluded that "there are no factual allegations in the second amended complaint from which we can infer that an objectively reasonable investor would have interpreted [the CEO's] statements" as referring to the 2017 models. Instead, all statements referred to "reductions in inventory that occurred in 2017 . . . a period in which the model year 2017 vehicles largely were not aged." *Id* at 149–50 (Kaplan, J., dissenting). Moreover, the CEO "twice explained on earnings calls in 2017 [that] clearing Arctic Cat's backlog of model year 2016 and older vehicles directly was tied to boosting sales of model year 2018 vehicles." *Id.* at 150.

148. Wochos v. Tesla, Inc., 985 F.3d 1180, 1184–86 (9th Cir. 2021).

149. *Id.* at 1187.

150. *Id.* at 1198 ("Tesla's stock price, which had closed at $356.88 on October 6, closed at $342.94 on the next trading day, October 9. However, the stock price immediately rebounded, closing at $355.59 on October 10 and trading between $350 and $360 over the next week.").

151. *Id.* at 1187.

152. *Id.* at 1185–86, 1187; *see id.* at 1184 (identifying offices held by the individual defendants).

153. *Id.* at 1184–85, 1198.

management for future operations, including plans or objectives relating to the products or services of the issuer," and "the assumptions underlying or relating to" those plans and objectives.[154] A private plaintiff cannot sue for recovery on such remarks made by a public company or a person acting on its behalf if the remarks are accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement[s]."[155]

Dividing the challenged statements into three categories, the Ninth Circuit turned first to statements in May 2017, including particularly that (i) "'preparations at our production facilities are on track to support the ramp of Model 3 production to 5,000 vehicles per week at some point in 2017'"; (ii) "'I don't know anything that would prevent us from starting firstly in July, and exceeding 5,000 units per week by the end of the year'"; (iii) "'Model 3 vehicle development is nearly complete as we approach the start of initial production in July of this year. . . . [P]reparations at our production facilities are progressing to support the ramp of Model 3 production to 5,000 vehicles per week at some point in 2017'"; (iv) "'Although we continue to remain on track with our progress at Gigafactory 1 [which was to manufacture the batteries for the Model 3s], given the size and complexity of this undertaking, it is possible that future events could result in . . . Gigafactory 1 taking longer to expand than we currently anticipate'"; and (v) a risk factor that the company identified: "'We may experience delays in realizing our projected timelines and cost and volume targets for the production, launch and ramp of our Model 3 vehicle, which could harm our business, prospects, financial condition and operating results.'"[156]

The plaintiffs pled that these statements were false because a director of manufacturing told Musk in May 2016 "that 'there was zero chance that the plant would be able to produce 5,000 Model 3s per week by the end of 2017,'" and that Tesla's vice president of manufacturing told Musk the same thing in that same month—with Musk responding that the director should "'look for new employment'" and forcing the vice president out of the company.[157] The complaint also alleged that (i) one former Tesla employee who had left the company in June 2017 said that the automated production line for Model 3s was not finished before he departed; (ii) that same former employee heard a technician say the assembly line would not be completed until 2018; (iii) a different former employee estimated that the line was only approximately 45 percent ready by September; and (iv) a third former employee stated that when he departed in mid-October 2017, he "'never saw a single Model 3 being constructed on the assembly line.'"[158] Yet another former employee, the plaintiffs alleged, said that he concluded in May 2017 that the Gigafactory would not produce 5,000 batteries

154. 15 U.S.C. § 78u-5(i)(1)(B), (D) (2018).
155. *Id.* § 78u-5(a)(1) & (2); (c)(1)(A)(i).
156. *Tesla*, 985 F.3d at 1190–91.
157. *Id.* at 1186.
158. *Id.*

per week in 2017 and that that factory did not shift from manual to automated production until the end of the third quarter.[159]

The court of appeals held that all but one of the challenged May 2017 statements were forward-looking by the definition in 15 U.S.C. § 78u-5.[160] Clearly, the representations that Tesla planned to produce 5,000 Model 3s during some week in 2017 was a management plan or objective.[161] As to the "various statements that [the company] was 'on track' to achieve this goal and that 'there are no issues' that 'would prevent' Tesla from achieving the goal," "[b]ecause any announced 'objective' for 'future operations' *necessarily* reflects an implicit assertion that the goal is achievable based on current circumstances, an unadorned statement that a company is 'on track' to achieve an announced objective, or a simple statement that a company knows of no issues that would make a goal impossible to achieve, are merely alternative ways of declaring or reaffirming the objective itself."[162] Moreover, those statements were covered by the 15 U.S.C. § 78u-5 definition because they constituted affirmations of assumptions on which achievement of the 5,000 cars per week goal was based and therefore protected by the statute's extension of its protection to the "assumptions" underlying "plans and objectives."[163] Because the plaintiffs did not challenge the adequacy of the cautionary statements with which Tesla accompanied these statements, the plaintiffs could not sue to recover on them.[164]

Importantly, the court distinguished this from the case in which a statement "goes *beyond* the assertion of a future goal, and beyond the articulation of predicate assumptions, because it describes specific, concrete circumstances *that have already occurred*."[165] In the event that such specific factual assertions accompany a forward-looking statement—such as that a goal "is achievable . . . because production of relevant units actually rose 75% over the last quarter or because the company has actually hit certain intermediate benchmarks"—"such factual assertions . . . are outside the safe harbor and potentially actionable."[166]

The Ninth Circuit declined to address the possibility that, if "the relevant Tesla officer *knew* that 'it was *impossible*' to meet the company's forward-looking projections, and 'not merely highly unlikely,' then any accompanying 'cautionary' language that failed to reveal this impossibility would not be 'meaningful.'"[167] Instead, the appellate court merely observed that "[p]laintiffs failed to plead such a known 'impossibility' during the entire May through August timeframe

159. *Id.*

160. *Id.* at 1192–93.

161. *Id.* at 1192.

162. *Id.* (emphasis by the court).

163. *Id.*

164. *Id.* at 1193 & n.3 ("Tesla acknowledged . . . that it had 'experienced in the past . . . significant delays or other complications in the design, manufacture, launch and production ramp of new vehicles' and that it 'may also experience similar delays . . . in bringing to market and ramping production of new vehicles, such as Model 3.'").

165. *Id.* at 1192 (emphasis by the court).

166. *Id.*

167. *Id.* at 1193 (quoting district court but adding emphasis).

in which Defendants made the various challenged statements."[168] In reasoning to this end, the appellate court dismissed the alleged statements that the director of manufacturing at the Model 3 plant and the vice president of manufacturing had told Musk that the 5,000 per week goal could not be met, as well as allegations that "'[s]uppliers had informed Tesla that the production timelines were impossible'" because none of those allegations pled that Musk ever accepted the naysaying as correct.[169] Indeed, the complaint suggested that Musk disagreed with these pessimistic projections since Musk allegedly told the director of manufacturing that he "'should look for new employment'" and "forc[ed]" the vice president out of the company by May 2016.[170]

The one statement in May 2017 that the Ninth Circuit found potentially outside 15 U.S.C. § 78u-5's protection was that Tesla "had 'started the installation of Model 3 manufacturing equipment.'"[171] The panel concluded that plaintiffs could only contend this representation was false by arguing that it referred to the automated production line.[172] But the plaintiffs had not pled "facts that . . . support this crucial premise in order to satisfy the PSLRA's requirement that a private securities plaintiff adequately plead 'the *reason or reasons* why [a] statement is misleading.'"[173] The statement itself "simply confirm[ed] that some unspecified 'manufacturing' equipment had been installed at the Tesla facilities" and the pled facts did not show that to be untrue.[174]

Turning from May to July 2017, the Ninth Circuit found only one statement attacked—Musk's representation during "a televised event at which Tesla 'handed over' the first Model 3s to buyers" that "'there's actually a total of 50 production cars that we made this month.'"[175] Here again, the court found the statement could only be false if, as plaintiffs argued, the term "'production car' would be understood as referring exclusively to the fully automated production of identical vehicles."[176] The Ninth Circuit found no allegations in the complaint supporting that premise.[177]

Finally moving to August 2017, the opinion addressed representations that (i) "'[b]ased on our preparedness at this time, we are confident we can . . . achieve a run rate of 5,000 vehicles per week by the end of 2017'"; (ii) "'we remain—we believe on track to achieve a 5,000 unit week by the end of this year'"; (iii) the company "was 'also making great progress on the battery front'"; (iv) a reference, in discussing projected margins for the third quarter to "'a gigantic machine producing—that's meant for 5,000 vehicles a week and it's producing a few hundred vehicles a week'"; (v) while Tesla "'may experience delays in

168. *Id.* at 1193–94.
169. *Id.* at 1194.
170. *Id.* at 1186.
171. *Id.* at 1192–93 (quoting company 10-Q).
172. *Id.* at 1193.
173. *Id.* (quoting 15 U.S.C. § 78u-4(b)(1)) (emphasis by the court).
174. *Id.*
175. *Id.* at 1194.
176. *Id.*
177. *Id.*

realizing our projected timelines and cost and volume targets for the production, launch and ramp of our Model 3 vehicle, . . . [w]e . . . have announced our goal to increase Model 3 vehicle production to 5,000 vehicles per week by the end of 2017'"; (vi) "'[w]hile we currently believe that our progress at [the battery factory] will allow us to reach our production targets, our ultimate ability to do so will require us to resolve the types of challenges . . . that we have experienced to date'"; and (vii) "'While we currently believe that we will reach our production targets, if we are unable to resolve ramping challenges and expand [battery] production in a timely manner and at reasonable prices, . . . our ability to supply battery packs to our vehicles, especially Model 3, . . . could be negatively impacted.'"[178]

The Ninth Circuit held that statements (i), (ii), and (v) were protected forward-looking statements because they constituted "reaffirmations of Tesla's year-end goal."[179] Numbers (v), (vi), and (vii) were also forward-looking statements "to the extent that they describe the future challenges Tesla might confront over the remaining months of 2017."[180] While the plaintiffs contended that these remarks misled "by failing to disclose that some of these types of risks had *already* been experienced," "these challenged statements contain no explicit or implicit representation that Tesla had *not* already experienced such issues," and (vi) "affirmatively acknowledge[d] that Tesla *has* 'experienced to date' the sort of 'challenges' that it would have to overcome in order to achieve its stated objective."[181] Rejecting the argument that statement (i)'s reference to "preparedness at this time" referred to a current fact that 15 U.S.C. § 78u-5 does not protect, the court of appeals held that "[s]uch a generic statement does not include the sort of 'concrete description' about the facts concerning the 'past and present state' of production" that would preclude statutory protection.[182] Finally, to whatever extent statements (iii) and (iv) referred to such facts, plaintiffs failed to plead them false.[183] The reference in (iii) to "great progress" on batteries "would potentially be an actionable false statement only if, as the district court put it, Tesla had been 'making no progress at all,'" which the complaint did not allege.[184] The court read (iv) to show a "contrast between third-quarter performance and Tesla's year-end goal" and amounted to only an explanation of projected Q3 numbers.[185] All of the August statements were therefore protected under 15 U.S.C. § 78u-5 from private Rule 10b-5 liability by Tesla's meaningful cautions or were not properly pled to be false.[186]

Significance and analysis. *Tesla* makes two noteworthy points. The first concerns allegations, in any case, that an executive made a false statement after

178. *Id*. at 1194–95.
179. *Id*. at 1195.
180. *Id*.
181. *Id*. at 1195–96.
182. *Id*. at 1196.
183. *Id*.
184. *Id*.
185. *Id*.
186. *Id*.

being given by an employee information telling the executive the truth. In *Tesla*, the complaint alleged specifically that two high-level manufacturing executives told Musk that the Model 3 plant would not be able to produce the 5,000 cars per week by the end of 2017. And the plaintiffs pled that Musk then forced both of them out of the company.[187] But instead of interpreting these events as indicating fraud, the Ninth Circuit saw them as showing that Musk simply was not convinced, since "Plaintiffs failed to plead any facts showing that Musk ever accepted those employees' views that the goal was impossible."[188] Accordingly, defense counsel should be alive to the possibility that a court will not necessarily infer that an executive's disagreement with an employee—even a high-level one—suggests fraud when the executive later makes a statement contrary to the judgment of the employee, even if the executive has fired the employee. Assuming that the disagreement is one of judgment, the executive may be seen as simply disagreeing with the employee's judgment, as could well be legitimate where the executive is charged with making the final determination. If this were not so, then plaintiffs could use the fact that an employee voiced a different judgment to support a fraud claim, even though in a complicated business setting differing judgments abound. On the other hand, there may be instances in which the disagreement with one or multiple employees—or others, such as suppliers—may be so baseless that the plaintiff could plausibly allege that the executive could not have believed his or her stated disagreement (sufficient for pleading falsity) and even so fantastic that the facts themselves could raise a strong inference of the executive's disbelief in his or her subsequent statement (sufficient for pleading scienter).

Tesla is noteworthy for the second reason that it deals with the puzzling inclusion in the definition of protected "forward-looking statements" of "the assumptions underlying or relating to" financial projections, plans and objectives, and statements of future economic performance.[189] Specifically, *Tesla* holds that "any scheduling" behind a statement of a management plan for future operations is protected—just like the forecast itself—because "[a]ny such schedule about how future production would play out on the way toward the announced goal is simply a set of the 'assumptions' about future events on which that goal is based."[190] Similarly, the Ninth Circuit held that "an unadorned statement that a company is 'on track' to achieve an announced objective, or a simple statement that a company knows of no issues that would make a goal impossible to achieve, are merely alternative ways of declaring or reaffirming the objective itself" and therefore protected just as is the statement of the management plan itself.[191] The court distinguished such remarks from "a concrete factual assertion about a specific present or past circumstance [that] goes *beyond* the assertion of a future goal, and beyond the articulation of predicate assumptions, because it

187. *See* text accompanying *supra* note 170.
188. *Tesla*, 985 F.3d at 1194.
189. 15 U.S.C. § 78u-5(i)(1)(D) (2018).
190. *Tesla*, 985 F.3d at 1192.
191. *Id.*

describes specific, concrete circumstances *that have already occurred*."[192] This suggests that a statement that a company has achieved a specifically identified milestone would not be protected even though the milestone is part of an overall schedule.

Scienter and scienter pleading. The SEC adopted Rule 10b-5 to implement Securities Exchange Act of 1934 ("Exchange Act") section 10(b), which prohibits, in the purchase or sale of any security, "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[193] A violation of Rule 10b-5 requires that the defendant have scienter, defined as either an intent to defraud or severe recklessness, sometimes characterized as "an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[194] Exchange Act section 21D(b)(2)(A) requires that, in a private Rule 10b-5 lawsuit seeking money damages, the plaintiff must plead "with particularity facts giving rise to a strong inference that the defendant acted with [this] required state of mind."[195] To comply with this statute, the private plaintiff must allege facts raising "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 intent."[196]

Last year, the Ninth Circuit affirmed dismissal of a Rule 10b-5 claim on the ground that the defendant investment bank more likely published a research report—with a per share valuation in excess of a client's announcement twenty-four hours later of an offering at a price below that valuation—due to a snafu rather than as part of a fraud.[197] The Fourth Circuit held that a Rule 10b-5 claim founded on after-the-fact admissions that a financing company had followed a poor strategy during the period of an alleged fraud asserted merely fraud by hindsight and did not raise a strong inference of scienter, particularly in light of the defendant entity's many warnings that it financed companies with limited financial resources and that those financings were highly speculative.[198] The First Circuit held scienter pleading sufficient on a theory of alternatives—either the top executives who touted a new product had apprised themselves of a new product's capabilities and discovered that it did not work, in which case the executives intentionally misled by their comments; or the officers

192. *Id.* (emphasis by the court).

193. Part 240—Rules and Regulations Under Securities Exchange Act of 1934, 13 Fed. Reg. 8177, 8183 (Dec. 22, 1948); 15 U.S.C. § 78j(b) (2018).

194. Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) (quoting Midwestern Okla. Dev. Auth., 428 F. Supp. 719 (W.D. Okla. 1976)); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12 (1976) (intent to defraud); SEC v. Watkins Pencor, LLC, 810 F. App'x 823, 830 (11th Cir. 2020) (severe recklessness); *In re* Triangle Cap. Corp. Sec. Litig., 988 F.3d 743, 751 (4th Cir. 2021) (same); Yan v. ReWalk Robotics Ltd., 973 F.3d 22, 39 (1st Cir. 2020) (extreme departure).

195. 15 U.S.C. § 78u-4(b)(2)(A) (2018).

196. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

197. *See infra* notes 200–26 and accompanying text.

198. *See infra* notes 227–52 and accompanying text.

had boasted about the product without apprising themselves of its inoperability, in which case they misled by recklessness.[199]

Analyst target price. The entity defendant in *Prodanova v. H.C. Wainwright & Co., LLC* ("Wainwright") provided investment banking services to clients in the life sciences industry and also employed stock analysts who published reports on such companies.[200] On October 10, 2017 at 4:03 AM, a Wainwright stock analyst published a report on MannKind Corporation ("MannKind"), a small publicly traded pharmaceutical company that had five days before announced a favorable FDA labeling decision that had boosted the company's stock price.[201] On the basis of "MannKind's publicly available cash flow and debt data, [the] expected 'near-term recapitalization and dilution,'" the analyst "set a $7 buy target" for the company's stock,[202] which had closed at $5.3300 on October 9.[203] The stock popped, closing at $6.71 on the 10th (an increase of 26 percent).[204] At 9:02 PM on October 10, however, Wainwright announced that it would provide exclusive placement services for a MannKind direct offering of 10,166,600 shares of common stock at $6 per share.[205] On the 11th, MannKind's stock dropped 18 percent, closing at $5.47/share.[206]

An investor sued, purporting to represent all who bought the stock in the less than twenty-four-hour period between Wainwright's publication of the analyst report and its announcement of the offering.[207] She alleged that Wainwright, its CEO, its COO, and the analyst, committed Rule 10b-5 fraud by issuing the $7 buy target.[208]

Agreeing with the district court judge who dismissed the case, the Ninth Circuit affirmed on the ground that the plaintiff failed to allege facts supporting a strong inference that any of the defendants acted with scienter.[209] The FINRA regulation requiring investment banks to erect information walls between research analysts and investment bankers at firms like Wainwright figured into the case.[210] So did the plaintiff's allegation that a confidential witness had identified an "industry custom—that investment banks generally maintain compliance departments that have visibility into both the research and investment banking groups"—a custom that the witness said Wainwright followed, with compliance departments putting bank clients who are about to make an offering

199. *See infra* notes 253–77 and accompanying text.
200. 993 F.3d 1097, 1103 (9th Cir. 2021).
201. *Id.* at 1103–04.
202. *Id.* at 1104.
203. *Historical Data, MannKind Corp. (MNKD)*, YAHOO! FIN., https://finance.yahoo.com/quote/MNKD/history?period1=1506902400&period2=1509321600&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true (last visited Mar. 18, 2022).
204. *Wainwright*, 993 F.3d at 1104.
205. *Id.*
206. *Id.*
207. *Id.*
208. *Id.* at 1104–05 (identifying individual defendants by position).
209. *Id.* at 1103, 1105, 1113.
210. *Id.* at 1103.

on a "watch list" in order, among other things, to prevent publication of analyst reports about the clients making those offerings.[211]

The appellate court found nothing in the complaint from which to infer a plausible motive for fraud.[212] The plaintiff argued that Wainwright was motivated to publish the $7 target price because that target would increase Wainwright's compensation from the $6 offering.[213] But Wainwright's compensation for the offering was fixed at 5 percent of the gross proceeds, the price of the offering was set, and Wainwright's percentage would not change whether the trading price for MannKind's stock was $6 or $7.[214] Although the plaintiff contended that Wainwright still had a motive for fraud because the $7 price target would ensure that all 10,166,600 shares were purchased, the complaint "allege[d] no facts to show that the Offering would not have sold out but for the Report's publication and the later increase in MannKind's share price and trading volume."[215] The Ninth Circuit commented, as well, that the awkward sequence—"issuing a $7 target price in a Report just before a dilutive offering of $6 per share—likely strained [the bank's] longstanding relationship with MannKind" and that "[t]he risk of losing a longtime client and publicly sullying its own reputation in the industry far outweighs the benefit of a slightly higher return on one transaction."[216]

The court found the scienter allegations against the individual defendants similarly deficient. The complaint pled "no facts alleging that [the analyst authoring the report] knew about the Offering."[217] Indeed, the information wall between analysts and investment bankers at Wainwright—which the plaintiff acknowledged—supported the conclusion that the analyst had no such knowledge.[218] As to the CEO, the complaint offered only that he was the "primary contact" for both the analyst and investment banking portions of the firm, without defining what that meant, and provided "no particularized facts" to show that the CEO had the necessary knowledge about the MannKind offering "when the [analyst] Report was published and [that he] had control over the Report's publication."[219] Nor did the complaint "present facts establishing his involvement with the compliance department's review of the Report."[220] While the COO supervised the compliance personnel, the plaintiff "offered no information on whether compliance personnel reported to [the COO] about the details of the Report or whether he was directly involved with the Report at all."[221] And while that officer "may have had a role in negotiating the Offering and known about it before the Report's publication[,] . . . without particularized allegations showing that he

211. *Id.* at 1105.
212. *Id.* at 1103.
213. *Id.* at 1107.
214. *Id.*
215. *Id.* at 1107–08.
216. *Id.* at 1107.
217. *Id.* at 1108.
218. *Id.*
219. *Id.* at 1109.
220. *Id.*
221. *Id.*

was directly involved with the Report and ignored its falsity, there is not enough factual support for a plausible inference of scienter."[222]

The court then considered the possibility that somehow the compliance department, as a whole, acted with scienter.[223] Beginning with the principle that this theory could only succeed if the plaintiff could "provide specific facts showing a connection between the false statement and the mindset of the person who made it," the Ninth Circuit found that "[t]he complaint contains no factual allegations that the watch list included the Offering, that a compliance officer checked the list and realized the conflict, and then that same officer approved the Report knowing that a conflict existed."[224]

Taking it all in all, and specifically considering "the lack of a plausible motive as well as the lack of particularized facts showing any individual's knowledge or deliberate recklessness about the Report's falsity at the time of its publication," the court found that "the most plausible inferences are that someone failed to put MannKind on the watch list, failed to properly check the watch list, or failed to realize that a conflict existed when approving the Report."[225] The circumstances looked like a "snafu"[226] rather than a fraud.

Unsuccessful business strategy. Triangle Capital Corporation ("Triangle") raised money from the public and loaned it out, during 2014 and 2015, in mezzanine financing, which was "'a hybrid of debt and equity financing that provide[d] the lender with the ability to convert to an ownership or equity interest in the

222. *Id.* at 1110.

223. *Id.*

224. *Id.*

The Ninth Circuit addressed the possibility that the "core operations" theory—which assumes top executives know facts about their companies' most important business—might apply. *Id.* at 1111–12. That court has employed this principle "(1) when [a complaint's allegations that the relevant operations were 'core' within the meaning of this principle], along with other allegations, support a cogent and compelling inference of scienter, (2) when [the allegations of predicate facts] are themselves particular and suggest that the defendants had actual access to the disputed information, and (3) in the 'rare circumstances' when they are not particularized, but 'the nature of the relevant fact is of such prominence that it would be absurd to suggest that management was without knowledge of the matter.'" *Id.* (quoting Police Ret. Sys. of St. Louis v. Intuitive Surgical, Inc., 759 F.3d 1051, 1062 (9th Cir. 2014) (quoting S. Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 785–86 (9th Cir. 2008))). The complaint did not satisfy the first condition because it did not supply the requisite allegations to invoke that theory; it contained only the "conclusory" pleading that the CEO and COO "'would have' been involved in creating and publishing the Report" "because of their positions in the company and their supervisory authority over the compliance department." *Id.* at 1112. The complaint did not satisfy the second condition because nothing in it suggested that, although "the compliance department checks for conflicts, . . . [Wainwright's] senior executives would have known about a particular conflict." *Id.* The complaint failed to satisfy the third condition because "[t]hough the compliance department checks for conflicts, it does not follow that [Wainwright's] senior executives would have known about a particular conflict." *Id.*

Finally, addressing the theory that Wainwright's "failure to promptly correct the Report supports an inference of intentional or deliberately reckless conduct," the court of appeals noted that neither it nor the Supreme Court "has recognized a duty to correct" and that the panel "decline[d] to do so in this case as well." *Id.* In any event, since the allegations did not support that any defendant "concealed information intentionally or with deliberate recklessness," this theory too lacked the "particularized allegations showing that any defendant acted with scienter." *Id.*

225. *Id.* at 1113.

226. *Id.* at 1107.

borrowing company in the event of default, after senior lenders [were] paid.'"[227] Triangle stated in its 2014 10-K that the companies to which it loaned "'would be rated below investment grade if they were rated,' which are commonly referred to as '"high yield" or "junk."'"[228]

In May 2017, one of Triangle's controlling shareholders, who was also an executive and director at the company, characterized 2014 and 2015 as "'a period where Triangle was [chasing] yield more than it should have.'"[229] In August 2017, Triangle disclosed that 5.4 percent of its total portfolio of loans (valued at cost) was now in "non-accrual" status.[230] In November 2017, Triangle disclosed that seven more investments had gone to non-accrual, and another controlling shareholder, who was also at this time the CEO, said that in 2014 and 2015 "'investment professionals . . . recommended to our former CEO [Tucker] to begin moving away from mezzanine structures and into lower yielding but more secure second lien unitranche and senior structures. . . . Unfortunately the strategic decision was made not to move off balance sheet in a meaningful way and [Triangle] continued to lead with a yield focused mezzanine strategy. In the process of doing so we added incremental exposure to a number of riskier credits, many of which are now underperforming.'"[231] He characterized this as "'the wrong strategic call.'"[232]

After Triangle's stock price dropped by 21 percent shortly after the last of these comments,[233] an investor (on behalf of a proposed class who bought Triangle stock during the period from May 7, 2014 to November 1, 2017) brought a Rule 10b-5 action against the company and executives.[234]

In affirming dismissal, the Fourth Circuit held that the plaintiff had "not satisfied the . . . heightened burden for pleading scienter."[235] Triangle's organization included "a team of outside experts" who "conducted the underwriting and due diligence, . . . then prepared a report for Triangle's 'investment committee,'" which then made final loan decisions.[236] The plaintiff sought to allege scienter, in part by pleading that those outside experts "at some unspecified time between 2013 and 2015" told members of Triangle's investment committee that Triangle should shift from emphasizing mezzanine financing to emphasizing unitranche financing that "'combin[ed] senior and subordinated debt into one

227. *In re* Triangle Cap. Corp. Sec. Litig., 988 F.3d 743, 745–46, 748 (4th Cir. 2021) (alteration in original) (describing Triangle offerings).

228. *Id.* at 746.

229. *Id.* at 748 (alteration in original); *id.* at 745–46 (describing the executive making this remark).

230. *Id.* at 748.

231. *Id.* at 748–49 (quoting the district court, in turn quoting an investor call); *id.* at 745–46, 748 (describing the executive making this remark).

232. *Id.* at 749.

233. *Id.*

234. *Id.* The panel incorrectly identifies the proposed class as "those who owned Triangle shares" during this class period. *Id.* But the complaint sought recovery for those who "purchased or otherwise acquired Triangle securities during the Class Period." Opening Brief of Appellant, *In re* Triangle Cap. Corp. Sec. Litig., 988 F.3d 743 (4th Cir. 2021) (No. 19-2162), 2020 WL 103913, at *11.

235. *Triangle*, 988 F.3d at 756.

236. *Id.* at 746.

package with a blended [interest] rate,' which both lowered a borrower's costs and presented other ancillary strategic benefits that mezzanine lending did not."[237] But the complaint "never specifie[d] when this advice was given, how firm in their conviction these investment advisors were in recommending that Triangle should avoid mezzanine deals moving forward, or what a mix of mezzanine and unitranche investments should look like."[238]

While the plaintiff contended that the May 2017 look-back assessment that the company had been "chasing" "yield more than it should have" showed the defendants' scienter, the Fourth Circuit responded that "this statement does not allow us to reasonably infer, much less strongly infer, that *at the time Defendants made those investments* they knew or recklessly disregarded the risk that pursuing yield necessarily required a sacrifice in the quality of their investments."[239] In the same way, the November look-back characterization of the decision to stand by mezzanine financing instead of switching to unitranche loans as the "'wrong strategic call'" showed only "buyer's remorse" rather than knowledge or reckless disregard of risks that exceeded those inherent in "the typical 'high yield' or '*junk*' securities that constituted Triangle's investment portfolio."[240]

The plaintiff pointed to a December 2015 industry report by Brown Gibson Lang & Company ("BGL"), arguing that it showed "that the mezzanine market was rapidly shrinking."[241] The court of appeals, however, found that "the Report contain[ed] just as many optimistic statements about the state of the mezzanine lending market as it [did] those expressing concern with the potential changes in that market."[242] And the BGL report included (i) comments from two mezzanine-lending firms that 2015 was exceptionally successful, (ii) most lending firms' "portfolio credit quality was 'strong . . . across most sectors'"; and (iii) "'[*d*]*efault risk remains low*.'"[243]

The plaintiff also sought to infer scienter from Triangle's change of CEO in early February 2016.[244] However, "without allegations demonstrating Defendants' contemporaneous knowledge that their 2014 and 2015 investments lacked quality, we find it difficult to give this regime change any weight toward a scienter inference."[245] Nor did Triangle's capital raises in 2016 and 2017 support such an inference on the theory that the defendants wanted "to keep share prices and dividends high in order to attract more investors."[246] The Fourth Circuit found such "generalized motives—which are shared by *all* companies— . . . insufficient to plead scienter."[247]

237. *Id.* at 747 (describing unitranche); *id.* at 751.
238. *Id.* at 752.
239. *Id.* (emphasis added).
240. *Id.* at 753 (emphasis by the court).
241. *Id.* at 751–52 (court's characterization of plaintiff's position).
242. *Id.* at 753.
243. *Id.* (emphasis by the court).
244. *Id.* at 748, 752, 753–54.
245. *Id.* at 754.
246. *Id.*
247. *Id.* (emphasis by the court).

Turning from these specifics to "holistically" examining the case, the Fourth Circuit found, instead of fraud, "the much stronger inference is that Defendants had an honest debate about the merits of a subjective business judgment, and in hindsight, simply made the wrong choice with some investments."[248] This fit with the BGL report, which recounted that different participants in the financing industry held "varying perspectives on the relative merits of mezzanine lending" and with Triangle's change of CEOs, which the court found more reasonably to reflect "an extension of that debate, rather than as an effort to cover up his (and others') fraud."[249]

Moreover, the court found that "[t]he breadth of Defendants' risk disclosures to investors further strengthens the competing inference of innocence," with Triangle's 2014 10-K advising that (i) the debtors to which Triangle loaned money "often 'ha[d] limited financial resources to meet future capital needs,' creating the risk that they 'may be unable to meet their obligations' to Triangle"; (ii) the information publicly available about those debtors was often sparse, which could prevent Triangle from making "'a fully informed investment decision'"; (iii) "Triangle's investments were by design 'highly speculative' and presented 'a higher amount of risk than alternative investment options and a higher risk of volatility or loss of principal'"; and (iv) accordingly, investing in Triangle "'may not be suitable for someone with [a] lower risk tolerance.'"[250] Triangle also stated that it "invested in '*junk*' rated companies" and that, because it operated in a competitive market, it "could be forced 'to accept less attractive investment terms.'"[251]

Significance and analysis. Altogether, the defense narrative sold well—that the plaintiff complained of "statements and omissions of facts arising from the execution of legitimate, subjective business judgments that, only when viewed in hindsight, allegedly become misleading."[252] This suggests that, as lawyers counsel clients that have suffered a business setback and wish to forthrightly admit to strategic mistakes, the attorneys should remind the clients to add, if this be the truth, that the unsuccessful strategy was adopted and pursued based on the information that the company had at the time and the honest judgment of management at the time. In most cases this should be true as it will have made no sense for the company and its executives to have deliberately adopted a losing strategy.

<u>Statements touting inoperable new product</u>. Carbonite, Inc. ("Carbonite") provided cloud-based backup and data protection services.[253] On October 18, 2018, Carbonite announced Server VM Edition ("VME") to provide backup for virtual computer environments.[254] On July 25, 2019, however, Carbonite stated that (i) it was withdrawing VME from the market and lowering revenue forecasts,

248. *Id.*
249. *Id.*
250. *Id.* at 755 (quoting 2014 Form 10-K).
251. *Id.* at 755–56 (quoting 2014 Form 10-K) (emphasis by the court).
252. *Id.* at 755.
253. Constr. Indus. & Laborers Joint Pension Tr. v. Carbonite, Inc., 22 F.4th 1, 4 (1st Cir. 2021).
254. *Id.*

attributing approximately one-third of that reduction to VME's demise, and (ii) the CEO had resigned.[255] The complaint in the ensuing Rule 10b-5 investor lawsuit alleged that VME had not successfully backed up even one customer's data before Carbonite launched the product and never did so after the launch, despite the efforts of a "tiger team" Carbonite created and multiple fixes and a large patch that the company distributed.[256] The complaint alleged that, before the October 2018 product introduction, "Carbonite employees . . . 'reported internally that the product was not ready and should not be running.'"[257]

Reversing dismissal,[258] the First Circuit focused on two statements by Carbonite executives.[259] In the first, the CEO said that VME "'significantly improves our performance for backing up virtual environments and makes us extremely competitive going after that market,'"[260] which was one in which Carbonite had not been performing well.[261] In the second, the CFO said that, with VME, "'we have put something out that we think is just completely competitive and just a super strong product.'"[262]

Rejecting the defense argument that these were "merely optimistic opinions," the appellate court held that the CEO's representation "could be reasonably construed in context as a statement of fact, at least to the extent that it plainly implied some better 'performance for backing up virtual environments,'" which was "false as compared to the complaint's contention that as of [the date of the statement] VME could not back up virtual environments."[263] While the CFO's statement was presented in the form of a "belief" (i.e., "'*we think*'"), the First Circuit concluded that plaintiffs "plausibly" alleged that it was false in "at least one and possibly all three" of the ways in which an opinion can be false or misleading under the Supreme Court's *Omnicare* decision.[264] For this purpose, the First Circuit interpreted *Omnicare* to mean that the CFO's statement "plausibly conveyed at least three facts: first, that [the CFO] actually believed VME to be 'completely competitive' and 'super strong'; second, that his opinion 'fairly align[ed] with the information' that [the CFO] possessed at the time; and third, that his opinion was based on the type of reasonable inquiry that an investor in context would expect to have been made."[265]

255. *Id.* at 5.
256. *Id.*
257. *Id.*
258. *Id.* at 4, 11.
259. *Id.* at 6–7.
260. *Id.* at 4 (Nov. 1, 2018 investor call).
261. *Id.* at 8 ("Carbonite's most senior officers promoted this new product to investors as shoring up one of the company's weaker market segments.").
262. *Id.* at 4–5 (Nov. 15, 2018 investor conference).
263. *Id.* at 6–7.
264. *Id.* at 7–8 (italics substituted for underline emphasis).
265. *Id.* While the defendants contended that the CFO's statements were forward-looking, the First Circuit answered that the CFO "used the present tense to describe Carbonite's beliefs about the then-existing status of a product that the company had already 'put out' into the market." *Id.* at 8.

The appellate court also held the complaint pled the CEO and CFO statements material because Carbonite's executives said that VME was important.[266] The CFO, for example, had stated that "'we've got a new offering out, [VME], which I think *is a really important product for us*, and I think it will help us address a pretty big segment of the market.'"[267]

Most important, however, the First Circuit found the complaint to plead facts raising a strong inference of scienter.[268] The plaintiffs pled "facts that, if true, make it clear that the Carbonite employees familiar with the product knew that it did not work yet," with "nothing in the alleged facts render[ing] less than sufficiently compelling the conclusion that [the CEO] and [the CFO] would have known of the product's status had they inquired."[269] The complaint also alleged "the company thought [VME] important enough to warrant two specific plugs from top management, thereby creating a very strong inference that the senior executives who gave those apparently prepared remarks touting the product would have paid at least some attention to the product's status."[270] The First Circuit therefore accepted the plaintiffs' reasoning that the pled facts led to either one of two conclusions, each sufficient for scienter—(i) the CEO and CFO had inquired about VME's operational status before making their statements, in which case they knew that the statements were false when they made them, or (ii) the CEO and CFO had not inquired about VME's capabilities, in which case they were reckless in a Rule 10b-5 sense when they spoke.[271]

Significance and analysis. The *Carbonite* opinion finds scienter pleading sufficient without pointing to any particular facts pled to show that either the CEO or CFO, at the time of their respective statements, knew that VME did not work. The decision points to no allegation that a particularly described document informed either executive of that fact before either made his statement.[272] The First Circuit does not say that the complaint referred to any confidential witness who claimed to have so informed either officer.

The reasoning displays some similarity to the "core operations" theory, which assumes for purposes of scienter analysis that top executives know important facts about products and services essential to their companies' survival.[273] But the First Circuit does not name that theory nor discuss the limitations that courts have placed on it in light of the statutory requirement that a complaint must "state with particularity facts giving rise to a strong inference that the defendant

266. *Id.* at 8.
267. *Id.* (italics substituted for underline emphasis) (court alteration for first letter of quote removed).
268. *Id.* at 8–11.
269. *Id.* at 10.
270. *Id.* at 9.
271. *Id.* at 9, 10.
272. The decision describes the complaint as "stat[ing] that Carbonite employees working on VME had reported internally before the launch that the product was not ready for market." *Id.* at 5. But the opinion does not state that plaintiffs pled that any particular report containing this information reached either the CEO or the CFO.
273. *See supra* note 224.

acted with the required state of mind."[274] The *Carbonite* reasoning also recalls the Seventh Circuit's comment that "it is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud. Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false."[275] But the First Circuit does not reference this prior authority either or suggest that such a conclusion would be possible—given the statutory pleading requirement—only in a rare case.[276]

Instead, *Carbonite* holds scienter pleading sufficient if (i) a company announces a new product in top officers' statements, (ii) said product does not work, and (iii) the top officers make complimentary comments about that product. Its reasoning is that either the top officers inquired about the product, learned about the product's deficiencies, and therefore intended their statements to deceive; or the top officers did not inquire and therefore made their statements with the severe recklessness that suffices for Rule 10b-5 scienter. Effectively, this takes the judge-made core operations exception and the judge-created Seventh Circuit hypothetical and expands them to the point that they threaten to swallow the statutory rule that scienter must connect specific facts linking the mental state of particular defendants to challenged representations.[277]

274. 15 U.S.C. § 78u-4(b)(2)(A) (2018). *See* KBC Asset Mgmt. NV v. DXC Tech. Co., 19 F.4th 601, 612 (4th Cir. 2021); Prodanova v. H.C. Wainwright & Co., LLC, 993 F.3d 1097, 1111–12 (9th Cir. 2021); *supra* note 224.

275. Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 710 (7th Cir. 2008).

276. *See supra* note 224.

277. Among other 2021 opinions addressing scienter pleading, two affirmed dismissals of Rule 10b-5 claims based on statements by acquiring companies about mergers they had made. In a case where an acquiror's stock price dropped after the company missed a post-merger margin prediction and again after the company announced that it would spend $200 million to complete integration of the target's operations, the Seventh Circuit found the inference that (i) the defendants "learn[ed] about difficulties over time," in the context (a) of an acquisition of another company about which the defendants "would have known comparatively little . . . until consolidation was underway" and (b) in which "the full extent of any roadblocks would take time to come to light" was a "better fit for the facts" than (ii) the plaintiff theory that the defendants "knew early in the process that consolidation would be costlier and more difficult than anticipated." City of Taylor Police & Fire Ret. Sys. v. Zebra Tech. Corp., 8 F.4th 592, 594–96 (7th Cir. 2021). The Eighth Circuit found no facts pled to raise a strong inference that the CEO of an acquiring company knew he spoke falsely when he said that his company had "fully integrated" the target's finance function or that he was reckless in making that statement, finding more plausible than fraud the inference that the CEO "made the statement because, as is typical for an executive overseeing 'an ongoing corporate consolidation,' he had 'limited information about the inner workings of' the legacy firms' finance departments." City of Plantation Police Officers Pension Fund v. Meredith Corp., 16 F.4th 553, 557–58 (8th Cir. 2021) (quoting *Zebra*, 8 F.4th at 596).

The Fourth Circuit affirmed dismissal of a Rule 10b-5 claim based on allegedly misleading statements about revenue, which the plaintiffs contended was being damaged by cost-cutting steps irksome to customers, finding among other things that a lawsuit by a former executive pleading that he warned that such steps would damage relations with customers reflected a business disagreement rather than raising a strong inference that the statements by the company were fraudulent. KBC Asset Mgmt. NV v. DXC Tech. Co., 19 F.4th 601, 608–09 (4th Cir. 2021). For examples of the statements the plaintiffs

Application of the* Affiliated Ute *presumption. In *Affiliated Ute Citizens of Utah v. United States*, the Supreme Court held that, in Rule 10b-5 actions "involving primarily a failure to disclose," "positive proof of reliance is not a prerequisite to recovery."[278] Instead, the "obligation to disclose and [the] withholding of a material fact establish the requisite element of causation in fact."[279] Underlying this principle is the notion that "[r]equiring a plaintiff to show a speculative state of facts, *i.e.*, how he would have acted if omitted material information had been disclosed, . . . would [impose] an unnecessarily unrealistic evidentiary burden."[280] Hence, the Court established "a rebuttable presumption of reliance" where "there is an omission of a material fact by one with a duty to disclose."[281]

Since it is possible for a plaintiff's case to rest on misrepresentations as well as omissions, courts have created protocols to determine whether and to what extent the *Affiliated Ute* presumption applies in such actions, with the Ninth Circuit ruling that the presumption "should not be applied to cases that allege both misstatements and omissions unless the case can be characterized as one that *primarily* alleges omissions."[282] In 2021, that court applied that protocol in a Rule 10b-5 action brought by purchasers of Volkswagen bonds while that automobile company concealed its installation of defeat mechanisms in its diesel-powered vehicles to hide their unlawfully high emissions.[283] The court of appeals reversed denial of summary judgment sought by the defendants,[284] finding that the lower court erred in ruling that the *Affiliated Ute* presumption applied because "although Plaintiff bases its claims on certain affirmative statements, 'Volkswagen's failure to disclose [the defeat device issue] is ultimately what drives Plaintiff's claims' and '[t]he case is best characterized as a nondisclosure case.'"[285]

challenged, see Brief of Appellants, KBC Asset Mgmt. NV v. DXC Tech. Co., 19 F.4th 601 (4th Cir. 2021) (No. 20-1718), 2020 WL 5514059, at *7 (Sept. 11, 2020). The Sixth Circuit affirmed dismissal of a complaint alleging an insurance company misled about the need to increase reserves for long-term care policies where the insurer had publicly stated that it would need to increase those reserves if the loss ratio exceeded 90 percent for a prolonged period and published that loss ratio every quarter—increasing the reserves after that ratio dropped below the 90 percent for three consecutive quarters. Pittman v. Unum Grp., 861 F. App'x 51 (6th Cir. 2021). The Ninth Circuit held that scienter allegations failed in a case concerning statements a utility made in the immediate aftermath of a gas leak. Plumley v. Sempra Energy, 847 F. App'x 426 (9th Cir. 2021). The Second Circuit reached the same conclusion in a case resting on statements by an issuer about fixing a blade problem in a turbine the issuer manufactured. *In re* Gen. Elec. Sec. Litig., 844 F. App'x 385 (2d Cir. 2021).

278. 406 U.S. 128, 153 (1972).

279. *Id.* at 154 (citing Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970)).

280. Basic Inc. v. Levinson, 485 U.S. 224, 245 (1988) (citations omitted).

281. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 159 (2008).

282. Binder v. Gillespie, 184 F.3d 1059, 1064 (9th Cir. 1999) (emphasis added).

283. *In re* Volkswagen "Clean Diesel" Mktg., Sales Pracs. & Prods. Liab. Litig., 2 F.4th 1199 (9th Cir. 2021), *rehearing & rehearing en banc denied*, 13 F.4th 990 (9th Cir. 2021) (mem.). A financing subsidiary of the American subsidiary of the German company, Volkswagen A.G., "issued the bonds . . . in this case in three private placements that closed on May 23, 2014, November 20, 2014, and May 19, 2015." *Id.* at 1202. The plaintiff placed orders to buy bonds "on May 15, 2014," the day the Offering Memorandum for the first bond offering was available. *Id.* The opinion sometimes refers to the Memoranda in the plural and sometimes to the Memorandum in the singular.

284. *Id.* at 1202, 1209.

285. *Id.* at 1203 (quoting district court, with alterations by the Ninth Circuit). The Puerto Rico Government Employees & Judiciary Retirement Systems Administration bought the bonds. *Id.* at

Disagreeing with that characterization, the court of appeals "acknowledg[ed] . . . that Plaintiff alleges an omission, and that omission looms large over Plaintiff's claims," but pointed out that the complaint included "more than nine pages of affirmative misrepresentations that were made by Volkswagen [in the bond offering materials] *and relied upon* by Plaintiff and its investment advisor."[286] For example, Volkswagen had represented that:

> Currently, Volkswagen offers in Europe [438/532] models or model variants with CO2 emissions below 130g CO2/km; [324/416] models emit less than 120g CO2/km and [54/85] models are currently already below 100g CO2/km.
>
> . . .
>
> A focal point of Volkswagen's current and future development activities is and will be innovative mobility concepts and the reduction of fuel consumption and emissions of the fleet.[287]

The plaintiff pled that such "statements were 'materially false' because Volkswagen 'did not intend to . . . reduce emissions' and 'misleading because they implied that Volkswagen had already reduced vehicle emissions when in truth Volkswagen's diesel engines emitted more pollutants than [it] represented.'"[288] Plaintiff also charged that such representations were "'misleading because they implied that Volkswagen's vehicles were compliant with emissions regulations' when they were not."[289] Similarly, Volkswagen boasted that it was a "leader" in "environmentally friendly mobility" and that it "closely coordinates technology and product planning with its brands so as to avoid breaches of emission limits, which would entail severe sanctions."[290] The complaint said that statements like these "were 'materially false and misleading because rather than actually being "environmentally friendly," [Volkswagen] diesel vehicles were equipped with secret defeat devices that allowed them to be sold under the pretense that their NOx emissions were within the legal limits when they actually exceeded such limits by as much as 40 times.'"[291] And such statements were, the plaintiff asserted, "'misleading because they failed to disclose that its basis for avoiding breaches of emissions limits . . . and offering environmentally friendly emissions standards was an unlawful scheme to meet regulatory emissions standards; and, that but for the illegal scheme, Volkswagen would not have been able to sell a substantial portion of its vehicles.'"[292]

The plaintiff, which was a public employee retirement fund,[293] affirmatively alleged that both it and its investment adviser "reviewed and relied upon the

1202. Santander Asset Management LLC advised on the purchase. *Id*. The defendants contended on summary judgment that there was "no evidence that [the retirement system] *or* Santander relied on the Offering Memoranda" for the bond deals. *Id*. at 1203 (emphasis added).

286. *Id*. at 1206 (emphasis by the court).
287. *Id*. at 1206–07 (quoting the Offering Memoranda).
288. *Id*. at 1207 (quoting plaintiff).
289. *Id*. (quoting plaintiff).
290. *Id*. (quoting plaintiff).
291. *Id*.
292. *Id*.
293. *Id*. at 1202.

information contained in the Offering Memorandum that corresponds to Plaintiff's Bond purchases, including the alleged omissions and misrepresentations."[294] Moreover, while plaintiff unquestionably pled "an omission regarding Volkswagen's use of defeat devices, . . . that omission is simply the inverse of the affirmative misrepresentations described."[295]

The Ninth Circuit concluded that this was not a case in which the plaintiffs had to shoulder "the difficult or impossible evidentiary burden of proving a 'speculative possibility in an area where motivations are complex and difficult to determine.'"[296] Accordingly, "the *Affiliated Ute* presumption of reliance d[id] not apply because Plaintiff can prove reliance through ordinary means by demonstrating a connection between the alleged misstatements and its injury."[297] Otherwise, since every misrepresentation is also an omission to say that it is untrue, the presumption—meant to cover exceptions—"would swallow the rule."[298]

Life sciences. The First Circuit affirmed a judgment in an SEC enforcement action against a CEO on a Rule 10b-5 claim where he responded to an analyst question about "further trials" by saying that there had been no "formal discussions" with the FDA about such trials even though, at a pre-NDA meeting documented by minutes, FDA representatives had recommended that the company conduct a second Phase 3 study for the relevant drug.[299] That same court, however, affirmed a defense judgment on the pleadings, where the issuer had encountered difficulties in outsourced manufacturing for finished drug tablets but had disclosed that it depended on a single source for this work and the outsource manufacturer had—before the interruption leading to the lawsuit—overcome problems before any tablet shortage occurred.[300]

FDA recommendation to conduct additional trial. AVEO Pharmaceuticals ("AVEO") created a drug to treat kidney cancer.[301] The company stated in its 10-K for 2011 that it expected to file an NDA in the third quarter of 2012.[302] In May 2012, AVEO published the results of a Phase 3 clinical trial (the "TIVO-1" study), showing that its drug outperformed an approved treatment on a progression-free survival metric but underperformed that competitor on overall survival ("OS").[303]

294. *Id.* at 1207. In addition, the plaintiff charged that Volkswagen's financial statements misled because they did not include provisions for losses related to the emissions scandal, understating its liabilities by not including those related to unlawful efforts to avoid emissions limits, and overstating operating profits, total assets, and shareholder equity because the numbers did not account for the illegality. *Id.*

295. *Id.* at 1208.

296. *Id.* at 1209 (quoting Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975)).

297. *Id.*

298. *Id.* The circuit court remanded the case "for the district court to further consider whether a triable issue of material fact exists." *Id.*

The panel split two to one. The dissenter saw the action as one in which "the plaintiff has alleged primarily an omissions case predicated on Volkswagen's material omission because the omission rendered those affirmative misstatements misleading." *Id.* at 1212 (Wallace, J., dissenting).

299. *See infra* notes 301–41 and accompanying text.

300. *See infra* notes 342–68 and accompanying text.

301. SEC v. Johnston, 986 F.3d 63, 66 (1st Cir. 2021).

302. *Id.* at 67.

303. *Id.* (the court giving the definitions so: "progression-free survival (the length of time from when the patient enters the study until the occurrence of either tumor growth or the patient's

Later that month, AVEO representatives met with FDA officials to discuss the company's plan to submit the NDA (the "pre-NDA meeting") and, during that meeting, the FDA representatives "recommended [(i)] that AVEO conduct a second Phase 3 study for [the drug] ('a second adequately powered randomized trial in a population comparable to that in the US')" and (ii) that the company "'conduct the final analysis of overall survival in the [TIVO-1] trial.'"[304] Minutes "jointly prepared with input from both FDA personnel and AVEO representatives" documented these recommendations, and AVEO's Chief Medical Officer ("CMO") reported the recommendations to AVEO's executive committee.[305] He also reported the FDA's "feedback" to AVEO's board of directors and to a steering committee for AVEO and another company, which had joint ventured with AVEO in developing the drug.[306] AVEO's CEO "was privy to all of these presentations" that the CMO made.[307]

In June 2012, AVEO's board approved an additional trial, while hoping that the FDA might approve the drug before that trial would end, and in July the company proposed to the FDA that the additional trial could be done after the drug was approved, requesting a meeting to discuss that possibility (the "Type A meeting").[308] On August 2, AVEO filed an 8-K with an attached earnings release that included a section titled "Regulatory Update" and said: "The FDA has expressed concern regarding the OS trend in [TIVO-1] and has said that it will review these findings at the time of the NDA filing as well as during the review of the NDA."[309] The release also stated that the company was undertaking "additional analyses to be included in the NDA submission that demonstrate that the OS data from TIVO-1 are consistent with improved clinical outcomes in [renal cell carcinoma] patients receiving more than one line of therapy."[310] But the release cautioned that, while AVEO was "continuing to work toward submitting the NDA by end of the third quarter[,] . . . there is a chance that the additional OS analyses may cause the submission to move into the fourth quarter."[311]

AVEO conducted an analyst call on that same day, for which the CEO "and his communications staff" created a script for addressing questions "about whether the FDA had recommended further trials."[312] The script called for responding that the agency had not "required an additional study" prior to approval of the company's kidney cancer treatment and to respond, "IF PUSHED," that AVEO "wouldn't want to speculate" on the FDA's future actions.[313] During the ensuing call, the CMO responded to an analyst question by stating that "we believe that

death)" versus "overall survival (the length of time from when the patient starts treatment until the patient dies from any cause)").

304. *Id.* at 67–68.
305. *Id.* at 68.
306. *Id.*
307. *Id.*
308. *Id.*
309. AVEO Pharms., Current Report (Form 8-K), exh. 99-1 (Aug. 2, 2021).
310. *Id.*
311. *Id.*
312. *Johnston*, 986 F.3d at 68.
313. *Id.*

the current data package should be sufficient" and added that "I can't speculate on what the agency might be thinking or what additional actions might be necessary."[314] The analyst "reasonably understood [this] response to mean that '[the CMO] ha[d] no idea what the FDA might outline as a way to fix the [OS] issue.'"[315] In response to a follow-up question by another analyst, the CMO said: "regarding any future study, I think—again, I just can't speculate on what the agency might want us to do in the future."[316] That analyst then authored a "report stating that 'new trials will not be required' for [AVEO's drug], and that report was sent to [AVEO's CEO] on August 3."[317] Yet a third analyst on the call interpreted the CMO's responses "to mean '[t]hat a discussion of another study has not come up.'"[318]

In late August 2012, the FDA told AVEO—in response to its request for a Type A meeting—that it had "significant concerns regarding" the "design" for the second study the company was proposing and "offered no encouragement that the recommended second study could be done post-marketing."[319] AVEO then declined to proceed with the meeting.[320]

After AVEO submitted its NDA in September and the FDA advised in November that the NDA provided enough information for agency review but cautioned that "the TIVO-1 overall survival data would be a 'review issue[ ]' considered by the Oncologic Drugs Advisory Committee (ODAC)," the company conducted a public offering in January 2013.[321] In the runup to ODAC review, the AVEO CEO spoke at a February 27, 2013 investment conference and, in response to the question, "Have you—either your partner or the FDA discussed any further trials in kidney cancer so far?"—the CEO responded: "We have not had any formal discussions, no."[322] He added that there was "a whole range of possibilities" from "go forth and sell [the] drug . . . [to] we would like to see a confirmatory trial before you start marketing this."[323] And the company participated in a meeting with the FDA to discuss an additional study, with the FDA "'encourag[ing]' AVEO to 'design the trial properly as soon as possible and [to] initiate it independent of the action taken on the current NDA submission.'"[324] When the company asked whether that study was required before any drug approval, the agency "responded that the NDA remained 'under review' and that 'no final decision ha[d] yet been made on the application.'"[325]

314. *Id.* at 69.
315. *Id.*
316. *Id.*
317. *Id.*
318. *Id.*
319. *Id.* at 69–70.
320. *Id.* at 70.
321. *Id.*
322. *Id.*
323. *Id.*
324. *Id.* (quoting minutes from Type A meeting).
325. *Id.* at 71.

When the FDA released the briefing documents for the ODAC and these documents "revealed to the public that the FDA had recommended at the May 2012 pre-NDA meeting that AVEO conduct another trial," AVEO's stock price declined 31 percent.[326]

The SEC sued the CEO for violation of Rule 10b-5.[327] A jury found for the agency.[328] The court imposed an officer and director bar to last for two years, as well as a $120,000 civil penalty and ordered disgorgement of $5,677.[329]

Affirming,[330] the First Circuit held that a reasonable jury could have found that the CEO had a duty to disclose the FDA's recommendation for a second study, made at the May 2012 pre-NDA meeting, because—without disclosing that recommendation—the statements by the CMO during the August 2, 2012 analyst call (prompted by the script that the CEO and the communications staff had prepared) and by the CEO himself at the February 27, 2013 investment conference were misleading.[331] The CMO's scripted response that he could not "speculate" on what the FDA was thinking "clearly impl[ied] that AVEO lacked knowledge short of speculation," whereas "no speculation was necessary on these topics after the FDA recommended in May 2012 that AVEO conduct a second study."[332] The CEO's own statement in February 2013 that the company had "'not had any formal discussions'" of further trials but that another study was just one of a range of possibilities "communicated to investors a false statement about the past: that the FDA had not formally discussed, much less recommended, a second study."[333]

The First Circuit similarly held that sufficient evidence supported the jury's conclusion that the CEO acted with scienter because, by his own testimony, "he learned of the FDA's recommendation to conduct another study shortly after the pre-NDA meeting" in May 2012—before the CMO spoke in August 2012 and before the CEO himself spoke in February 2013.[334] Though the CEO pointed out that "he and AVEO disclosed the TIVO-1 data, the FDA's overall survival concerns, and their uncertainty about whether a second study would be necessary to obtain NDA approval," the court held that "a defendant's disclosure of a subset of unfavorable facts does not prevent that defendant from misleading investors, with scienter, about another known and material unfavorable fact."[335] While the CEO claimed good faith because counsel for the company

326. *Id.*
327. *Id.*
328. *Id.*
329. *Id.*
330. *Id.* at 67, 77.
331. *Id.* at 71–74. The court summed up its duty-to-disclose conclusion: "a reasonable jury could find that Johnston used carefully crafted half-truths and distortions to convey a false understanding of the FDA's feedback on the company's clinical trial and thereby violated his duty to make accurate statements regarding material facts." *Id.* at 74.
332. *Id.* at 72.
333. *Id.* at 73.
334. *Id.* at 74.
335. *Id.* at 75.

and the underwriters provided negative assurance letters[336] for the January 2013 offering, (i) those assurances predated the CEO's misleading comment at the investment conference a month after the offering and therefore could not have approved that comment; and (ii) the letters had circumscribed their scope to refer only to "'the Registration Statement,' 'the Pricing Disclosure Package,' and 'the Prospectus,' which incorporated AVEO's August and November Form 10-Qs by reference" and further by "the information the law firms gathered during their respective due diligence processes."[337] All in all, "because Johnston's calculated statements were inconsistent with known facts, a reasonable jury could conclude that he made those statements at least with a high degree of recklessness" sufficient for Rule 10b-5 scienter.[338]

Significance and analysis. The opinion deliberately skirts the question of whether the CEO was liable for the statement made by the CMO.[339] The entire analysis, therefore, hung on whether the CEO committed a securities fraud by saying, in response to a question about "further trials," that there had been no "formal discussions" with the FDA.

True, the pre-NDA meeting in May 2012 was sufficiently formal to be documented by minutes. On the other hand, the 10-Q that AVEO filed in August 2012 stated that the company "'cannot be certain as to what type and how many clinical trials the FDA . . . will require us to conduct before we may successfully gain approval to market [the kidney cancer drug]'" and "that '[p]rior to approving a new drug, the FDA generally requires that the efficacy of the drug be demonstrated in two adequate and well-controlled clinical trials.'"[340] Moreover, the agency had declined, even in March 2013, to say whether a second trial would constitute a requirement for drug approval.[341] This SEC enforcement action suggests that risk warnings a life science company publishes may not cure failure to disclose what a court later finds to be material communications with the FDA, even when those risk warnings address the same subject as the communications.

Disclosure of manufacturing problems. Keryx Biopharmaceuticals, Inc. ("Keryx") developed and sold one drug.[342] Keryx outsourced production, with the active pharmaceutical ingredient ("API") produced by multiple companies and a single company—Norwich Pharmaceuticals, Inc. ("Norwich")—manufacturing the finished tablet.[343] On August 1, 2016, Keryx disclosed "that [(i)] a supply

336. Negative assurance letters state that counsel does not know of any false statements or statements that mislead by omission in designated offering documents. *See* William O. Fisher, *Obligations of Attorneys in Public and Private Offerings*, *in* VENTURE CAPITAL & PUBLIC OFFERING NEGOTIATIONS 36-7, 36-8 (Michael J. Halloran et al. eds., 3d ed. rev. 2019).

337. *Johnston*, 986 F.3d at 75.

338. *Id.* at 76.

The jury had also found for the SEC on its claim that the CEO violated Rule 13a-14 by falsely certifying AVEO's 10-Qs filed in August and November 2012 and its 10-K filed in March 2013. *Id.* at 76 n.8.

339. *Id.* at 73.

340. *Id.* at 69.

341. *Id.* at 71.

342. Karth v. Keryx Biopharmaceuticals, Inc., 6 F.4th 123, 126 (1st Cir. 2021).

343. *Id.* at 127.

interruption is going to occur due to a production-related issue" at Norwich; (ii) "current inventories of [its drug] are not sufficient to ensure uninterrupted patient access to this medicine"; (iii) "Keryx is working with its existing manufacturer to resolve the production-related issue and rebuild adequate supply"; and (iv) the company "has been working to bring a secondary manufacturer online to supply finished drug product," having "recently filed for approval of this manufacturer with the [FDA]."[344] After the price of Keryx stock dropped by 36 percent on this announcement,[345] an investor who bought the stock in July 2016 brought a Rule 10b-5 action on behalf of all who purchased the stock between May 8 and August 1, 2016, on the theory that the company and its top officers misleadingly understated—in disclosures published in February and April 2016—the risk from relying on one manufacturer for the second stage of production, despite knowing of production problems at Norwich.[346]

Affirming a defense judgment after the district court had granted judgment on the pleadings to defendants and denied plaintiff's motion to amend,[347] the First Circuit analyzed the facts known to Keryx in February and April of 2016 to determine whether disclosures made then omitted a material risk that second-stage production problems would generate a finished tablet supply shortage.[348]

In February, a company press release stated that "'the fundamentals of [the Keryx drug] are solid,'" revealed that "'[w]e currently depend on a single supply source for [our] drug product,'" cautioned that "'[i]f any of our suppliers were to limit or terminate production, or otherwise fail to meet the quality or delivery requirements needed to supply [the drug] at levels to meet market demand, we could experience a loss of revenue, which could materially and adversely impact our results of operations,'" but also reassured that the company "'believe[d] that [it had] established contract manufacturing relationships for the supply of [the drug] to ensure that [it would] have sufficient material for clinical trials and ongoing commercial sales.'"[349] To support his position that this language misled by failing to disclose a looming supply deficit, the plaintiff pled "that in early February, Norwich was struggling to produce enough sample-size bottles of [Keryx's drug]."[350] But he did "not plead that a supply interruption actually occurred (including of sample-size bottles), that anyone at Keryx thought such an interruption was approaching, or that these production problems impacted Keryx's revenue at all."[351] Moreover, the record revealed that (i) Keryx assessed in January that 90 percent of the tablets Norwich produced satisfied all quality standards; (ii) "Keryx was having no issues with production of [its drug] for commercial sales and finished February of 2016 with over one

344. Keryx Biopharmaceuticals, Inc., Current Report (Form 8-K) (Aug. 1, 2016); *Karth*, 6 F.4th at 132.
345. *Karth*, 6 F.4th at 131–32.
346. *Id.* at 132.
347. *Id.* at 126, 141.
348. *Id.* at 134–40.
349. *Id.* at 129 (quoting a Feb. 25, 2016 press release).
350. *Id.* at 139.
351. *Id.*

thousand commercial-use bottles beyond what the company predicted it needed for the coming month"; (iii) "Keryx understood from historical experience that occasional production stoppages at Norwich had not caused shortages of [the drug]" since "in 2014, 2015, and several times in 2016, Norwich stopped production, often due to issues with API produced by first-step manufacturers, and each time, Norwich resumed production before any supply shortage panned out"; and (iv) the plaintiff pled "no facts suggesting Keryx should have thought, for the first time, that a production stoppage would necessarily yield an uncorrectable supply interruption."[352]

On April, 28, 2016, Keryx published its first-quarter financial results, in which the company repeated the warnings that it "'depend[ed] on a single supply source for [our] drug'" and that a supplier limitation or termination of production could lead to a revenue decline that "'could materially and adversely impact our results of operations.'"[353] In a related conference call, the COO reported "that Keryx was 'off to a good start' [for the current quarter] . . . that the company had 'established solid fundamentals for [its drug], including enhancing brand awareness'" and "that Keryx had expanded its sales force and was 'confident in [its] ability to achieve [its] net sales guidance.'"[354]

The plaintiff alleged that Norwich had stopped production about a month earlier, on March 24, but the court pointed out that Norwich had successfully solved the problem, having to do with the API provided to it by a first-stage contractor, by switching API suppliers.[355] The plaintiff also alleged that Norwich had advised Keryx on April 27—one day before the company published financial results and hosted the quarterly conference call—that it had found one batch of API it received to be contaminated and that tablet production did not recommence until June.[356] Nevertheless, "Keryx's supply exceeded demand until August."[357] Since the supply was on target with the company's projections in mid-April, "it seemed Keryx had solved any production problem before anyone in the company thought the patient supply of [the drug] was at risk."[358] Moreover, the court read the complaint as meaning that Norwich "had given Keryx no reason to think there was a likely systemic production problem" at the time Norwich informed Keryx of the stoppage on the day before the release of the quarterly financial numbers and the accompanying analyst call.[359] Indeed, Norwich had thought then that the matter was an "'isolated incident.'"[360] And by this time, Keryx "had even more reason than in February of 2016 (when it published the other challenged disclosure) to think that Norwich would rectify any

352. *Id.* Indeed, "[t]hose stoppages were apparently so inconsequential that Keryx had an excess stock of 1,632 bottles of [the drug] slated for destruction by March of 2016." *Id.*

353. *Id.* at 130.

354. *Id.* at 130–31, 127 (identification of officer).

355. *Id.* at 139–40.

356. *Id.* at 131.

357. *Id.* at 140.

358. *Id.*

359. *Id.*

360. *Id.*

production problems before they impacted supply, because Norwich had successfully done so in February and March."[361] The court concluded that "[a] risk disclosure is not fraudulent simply because a company makes reasonable assumptions that, in retrospect, prove incorrect."[362]

Significance and analysis. The First Circuit opinion contains some very unfortunate language. The panel analogizes risk warnings to cautions provided to a hiker, "where one cannot tell a hiker that a mere ditch lies up ahead, if the speaker knows the hiker is actually approaching the precipice of the Grand Canyon."[363] This in turn drives the court to define the question as whether the risk, should it materialize, "is akin to the Grand Canyon (and therefore a disclosure is misleading if it frames the risk as merely hypothetical) . . . [or] a situation merely risky (i.e., simply a ditch)."[364] Warning of a mere risk is inadequate if "[a] securities fraud defendant is at the edge of the Grand Canyon where the alleged risk ha[s] a 'near certainty' of causing 'financial disaster' to the company."[365]

This is neither sound legal reasoning nor common sense. The danger from a risk—and whether a caution adequately discloses it to investors—depends on both the magnitude of the effect should the risk mature and the probability that it will mature. Thus, a reasonable investor would view a risk as relevant to his or her investment decision depending on the balance of both these factors. Plenty of risks would be important to an investor if the probability of their maturation is high, even if the matured risk would not wreak "financial disaster" on the issuer. Indeed, this is the message of *Basic Inc. v. Levinson*, which announced the probability/magnitude test for materiality of developments in the merger and acquisition context.[366] Applying that test, the question in *Keryx* was not whether the company was approaching a company-killing event but whether the cautions Keryx published adequately warned investors of the probability that a manufacturing issue could occur that could so significantly affect the stock price that it could decline to an important degree (which the actual 36 percent surely was) when the issue was disclosed.[367] The better focus would have been on the probability of the supply interruption, which could have been evaluated as so low (due to the history of Norwich overcoming previous problems) that the risk

361. *Id.*

362. *Id.* The First Circuit was unimpressed with a 2014 report to Keryx that concluded Norwich had not then "'demonstrated that the manufacturing process w[ould] consistently produce product that [met] final specifications.'" *Id.* That amounted only to a statement that the Norwich production "was not guaranteed to be flawless." *Id.* In any event, Keryx had warned investors that, if its contractor manufacturers "were to 'fail to meet the quality or delivery requirements needed to supply Auryxia at levels to meet market demand, [Keryx] could experience a loss of revenue.'" *Id.* at 141. The panel also rejected the plaintiff's contention that the Keryx cautions were "'too boilerplate,'" responding that "the disclosures here specifically identif[ied] the risk—the use of a single manufacturer who could fail to produce enough [of the drug] 'to meet market demand'—and explained what that would mean for investors—'a loss of revenue.'" *Id.*

363. *Id.* at 137.

364. *Id.*

365. *Id.* (quoting Hill v. Gozani, 638 F.3d 40, 59–60 (1st Cir. 2011)).

366. 485 U.S. 224, 238–39 (1988).

367. Indeed, the very fact that the stock price dropped so far so fast suggests that this was an important event, if not a "Grand Canyon" one.

disclosures did not materialy mislead despite the significant degree to which a production interruption would damage this one-drug company.

The *Keryx* opinion warrants one further comment. The decision adopts a flippant style, with the court titling its analysis "Our Take" and ending its reasoning with the snappy tag line that it "may be a tough pill to swallow."[368] Taken in conjunction with its suspect homespun "Grand Canyon" analysis, this rhetoric suggests a too casual approach to a serious securities question, particularly since the majority of those who would read this decision would be specialty practitioners who would be unimpressed with the breezy work.

Insider trading. Rule 10b-5 imposes insider trading liability under multiple theories. In 2021, the Second Circuit affirmed the conviction of a tipper who provided information about a merger and who the government pursued on the misappropriation theory.[369] The Second Circuit also affirmed the conviction of a defendant who participated in a conspiracy to steal press releases from business wire services before the services published those releases and who the government pursued on the theory that the hackers in the conspiracy committed Rule 10b-5 deception by using stolen employee login credentials and misrepresenting themselves as those employees when they hacked in to obtain the press releases.[370]

Misappropriation theory used to convict tipper providing information about merger. The federal government brought a criminal case against Benjamin Chow ("Chow"), charging that he violated Rule 10b-5 by passing material nonpublic information about the acquisition of Lattice Semiconductor Corporation ("Lattice") to Shaohua Yin ("Yin").[371] The case rested on the misappropriation theory of insider trading, which posits that the recipient of such information from a source to whom the recipient owes a duty of trust and confidence cannot then, for his own benefit and without informing the source, transmit the information to a third party who the recipient reasonably believes will use it for trading.[372]

Chow led the negotiations for two companies that successively sought to acquire Lattice.[373] Yin, "through accounts held in names other than his own," purchased millions of Lattice shares as those negotiations proceeded, selling about half of them—for an approximate profit of $5 million—on the day after the Lattice acquisition was announced.[374]

Affirming Chow's conviction,[375] the Second Circuit addressed four issues. First, it held that two confidentiality agreements—one a nondisclosure agreement

368. *Id.* at 133, 141.
369. *See infra* notes 371–98 and accompanying text.
370. *See infra* notes 399–405 and accompanying text.
371. United States v. Chow, 993 F.3d 125, 128–29, 139 (2d Cir. 2021).
372. *Id.* at 134, 135–37.
373. *Id.* at 129, 130–31.
374. *Id.* at 129. The negotiations began in April 2016. *Id.* By June, the Yin accounts held only 34,000 Lattice shares. *Id.* at 132. The tipping began in early July. *Id.* By the end of October, the Yin accounts owned 6.2 million shares. *Id.* at 133. Lattice announced the acquisition on November 3, before the markets opened. *Id.* The Yin accounts sold something over 3.7 million Lattice shares on that day. *Id.* The head of FINRA's Criminal Prosecution Assistance Group calculated the profit from those sales at more than $5 million. *Id.*
375. *Id.* at 129, 144.

("NDA") that Chow signed for the first company bidding for Lattice and the other an NDA that he signed for the second company[376]—supplied the duty of trust and confidence sufficient to support that element of the offense.[377]

Second, the court found the evidence sufficient for the jury "to infer that Yin's investment of so many millions of dollars to buy Lattice stock immediately after communications with Chow was based on material nonpublic information he received from Chow."[378] Chow's phone records "showed that he had known Yin since at least 2011."[379] On July 5, 2016, only two days prior to Chow providing the first offer to Lattice from the first of its suitors, Chow and Yin met at a Starbucks in Beijing, and one of the Yin accounts bought 248,268 Lattice shares hours before NASDAQ next opened for trading.[380] On July 12, Yin sent Chow analyst reports on Field-Programmable Gate Arrays ("FPGAs") semiconductor manufacturers, significant because Lattice produced FPGAs, and asked two investment bankers at Jefferies to connect Chow with a semiconductor analyst at that firm, telling the bankers that Chow would be on the West Coast of the United States (Lattice was headquartered in Portland, Oregon) for the next three weeks.[381] On that same day, Chow and Yin talked by phone and texted, with Yin offering to connect Chow with "'a CFIUS [Committee on Foreign Investment in the United States] lawyer,'" significant because purchase of Lattice by either of the suitors Chow represented would have to be cleared by the CFIUS.[382] During the ten days following July 12, Yin accounts bought another 280,283 Lattice shares.[383]

On August 10, 2016, Chow advised Yin via a chat message "that he was 'making a deal [and] can't come back,'" with Yin replying that "'being [o]n the west coast is better than being in Beijing,'" and Yin accounts purchased 120,000 more Lattice shares "less than a minute after the NASDAQ next opened."[384] On September 12, the day before the second suitor provided a draft merger agreement to Lattice, Chow and Yin agreed to meet in Beijing, and the Yin accounts bought in excess of 100,000 Lattice shares at market open on September 13th, purchasing 1,005,111 more over the following three days.[385] On September 21, a Yin voicemail to Chow said that Yin had received information that "'the company

376. *Id.* at 129–31.

377. *Id.* at 139. The court elaborated that "in both NDAs each party agreed not to disclose any confidential or proprietary information of the other; and . . . '[t]he fact of the [Parties'] exploration and evaluation of' the potential acquisition of Lattice was explicitly classified as 'Proprietary Information' that was to remain 'Confidential.'" *Id.* (alteration in original) (record citations omitted). See also *id.* at 129–30 for longer quotations from the agreements, which forbade a party "'to disclose, commercialize, or use any Proprietary Information of the other Party for any purpose, except to evaluate and/or engage in discussions regarding, and potentially pursue and effect, the potential business transaction involving the Parties.'"

378. *Id.* at 141.

379. *Id.* at 139.

380. *Id.* at 132.

381. *Id.* at 129, 132. Ultimately, the merger did not close precisely because CFIUS did not approve. *Id.* at 131.

382. *Id.* at 131, 132.

383. *Id.* at 132.

384. *Id.*

385. *Id.*

that does FPGA'" "had 'considerable concern with regard to CFIUS,' that 'they may not even consider the Chinese buyer,' and that Chow should be 'mentally prepared for it,'" with Chow responding that "'right now we are over at this (unintelligible) company. We should already be signing the contract soon.'"[386] During the next three weeks, Yin accounts acquired an additional 2,206,760 shares.[387] After another Beijing meeting between Chow and Yin, there followed seven days during which the Yin accounts bought yet 1,931,102 more.[388]

In addition to this chronology of contacts between the two and interspersed stock buys, Yin texted an associate—after the email exchange about the CFIUS concerns—"saying that [his] 'friend' had recently reported making progress with 'LSCC'—the NASDAQ symbol for Lattice."[389]

With all of this "it was permissible for the jury to infer that Chow intentionally disclosed information to Yin about the existence and progress of his acquisition discussions with Lattice," "especially in contrast to the prior lengthy periods when Chow and Yin apparently had had no contact."[390]

Third, the panel found sufficient evidence to support a conclusion that Chow tipped Yin for Chow's personal benefit, noting that "'as is clear from the purpose of the personal benefit element, the "broad definition of personal benefit set forth in *Dirks*," and the variety of benefits we have upheld, the evidentiary "bar is not a high one."'"[391] Here, (i) "Chow had asked Yin to provide him with analyst reports on the semiconductor industry"; (ii) he "had asked Yin to recommend possible limited partners for [a venture capital fund with which Chow was associated]"; (iii) "Yin provided Chow with information on other manufacturers of FPGAs and on users of FPGAs"; (iv) "Yin used his contacts with two Jefferies investment bankers to connect Chow with a Jefferies analyst knowledgeable about FPGAs, and to link those investment bankers with Chow's fund for profitable undertakings"; and (v) Yin sent Chow "gifts of wine and cigars."[392]

Fourth, the court of appeals concluded that the prosecution was properly venued in the Southern District of New York.[393] The applicable statute provides that "'[a]ny criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred,'" giving expansive elaboration to the constitutional provision providing a defendant "the right to be tried in the 'district wherein the crime shall have been committed.'"[394] The southern district satisfied these

386. *Id.* at 132–33.

387. *Id.* at 133.

388. *Id.*

389. *Id.* at 140.

390. *Id.* at 141.

391. *Id.* at 142 (quoting United States v. Martoma, 894 F.3d 64, 76 (2d Cir. 2017) (quoting SEC v. Obus, 693 F.3d 276, 292 (2d Cir. 2012)) (referring to Dirks v. SEC, 463 U.S. 646 (1983))).

392. *Id.*; see *id.* at 131 for reference to venture fund. The panel also breezed through other elements, concluding that the evidence summarized above "permitted the inference that Chow intended that Yin would make purchases of Lattice shares based on the information he received from Chow. The jury was entitled to infer that Chow did not [act] inadvertently." *Id.* at 142.

393. *Id.* at 143–44.

394. *Id.* at 143 (alteration in original) (first quoting 15 U.S.C. § 78aa, then quoting U.S. Const. amend. VI).

standards because it was "the district in which the NASDAQ is located, where the shares of Lattice stock were listed and traded, where the brokers for the sellers in a significant number of Yin's Lattice share purchases were located, and where Yin's purchases of Lattice shares were executed, cleared, and recorded."[395]

Significance and analysis. *Chow* continues the Second Circuit's questionable reliance on the notion that one of two contractual counterparties can become a "temporary insider" at the other counterparty, thereby owing a *fiduciary* duty of confidentiality simply by virtue of signing a confidentiality agreement.[396] The circuit announced this somewhat startling notion in 2020 in its *United States v. Kosinski* decision.[397] Not only has the Second Circuit imported the term "temporary insider" from the classical theory of insider trading—rooted in the fiduciary relationship of corporate insiders to their corporation and its shareholders—into the very different misappropriation theory, but the circuit's use of the term in the misappropriation context involves judicial gymnastics to find a "fiduciary" relationship in virtually any contract including a confidentiality provision, even one in an acquisition in which the buyer is without question on the other side of the transaction with diametrically opposed interests to those of the seller. Far better to simply embrace SEC Rule 10b5-2(b)(1) that pronounces—without use of the word "fiduciary"—that, for purposes of the misappropriation theory of insider trading, the requisite duty of trust or confidence is present "[w]henever a person agrees to maintain information in confidence."[398]

Dorozhko theory used to convict trader who used electronically stolen information obtained through misrepresented identities. In addition to the misappropriation theory employed in *Chow*, Rule 10b-5 imposes classical theory insider trading liability on officers, directors, and employees of companies who trade in their company's stock on the basis of material nonpublic information that they received for the purpose of benefiting the corporation and that they do not disclose—before the trades—to counterparties on those trades, in violation of the fiduciary duty that the insiders owe to those counterparties.[399] But there is a third theory, enunciated by the Second Circuit in *SEC v. Dorozhko*, which creates liability for use of material nonpublic information for trading purposes—or transmission of

395. *Id.* The court noted that, while the prosecution had the burden of proving proper venue, that burden was by a preponderance of evidence only, "as venue is not an element of the crime." *Id.* Commenting broadly, it said: "Where the defendant is charged with an offense involving the trading of securities on a stock exchange located in the SDNY, venue in that district is appropriate." *Id.* The panel also stated that the jury "was entitled to infer that" Chow—who had "college and postgraduate degrees includ[ing] a Master's degree in business . . . [—]would have been aware that the shares of Lattice were listed and traded on the NASDAQ stock exchange, which was in Manhattan." *Id.* at 143–44.

396. *Id.* at 138.

397. *Id.* (citing United States v. Kosinski, 976 F.3d 135, 144 (2d Cir. 2020)).

398. 17 C.F.R. § 240.10b5-2(b)(1) (2022). Note that *Kosinski* did not cite that rule. But *Chow* did, though without substantive discussion. *Chow,* 993 F.3d at 128–29 (including the rule in recitation of the counts on which Chow was convicted); *id.* at 138 (citing the rule only in passing and on the way to the farfetched conclusion that any confidentiality agreement imposes a fiduciary duty).

399. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997); Chiarella v. United States, 445 U.S. 222, 226–29 (1980); Dirks v. SEC, 463 U.S. 646, 653–54 (1983).

that information to others for that purpose—where the defendant has used or transmitted information obtained through deceptive means, and this theory applies even when neither the defendant nor a fellow schemer owes a fiduciary duty to the individual or entity from which the information was extracted by that deceit.[400]

In 2021, the Second Circuit employed this latter theory to affirm a conviction in *United States v. Khalupsky*.[401] The government charged that Khalupsky and a second appealing defendant, Korchevsky, participated in a conspiracy involving Ukrainian hackers who intruded into the servers of business newswire services to steal the contents of press releases before the services published them, with the information passed to others in the conspiracy, including the two appellants, who used the information to buy and sell securities before the newswires distributed the releases.[402]

Addressing his challenge to the sufficiency of evidence on the charges that he substantively violated Rule 10b-5, the court rejected Korchevsky's challenge "that he did not engage in a 'scheme or artifice to defraud'" because "he did not owe a fiduciary duty to investors or potential investors in the companies whose press releases were stolen, and because any deception employed to obtain the releases did not target the investors."[403] The proof showed that "the hackers extracted employee login credentials and used those credentials to intrude into the system's more secure areas" and therefore "the subsequent use of stolen employee login credentials to gain further system access was deceptive. Every time the hackers attempted to access parts of the system by entering stolen credentials, they misrepresented themselves to be authorized users."[404] Given that straightforward deception, the government had no need to prove a violation of any "fiduciary duty" of the sort comprising the basis of other theories of insider trading.[405]

Manipulation. Credit Suisse ("CS") sold an exchange-traded note ("ETN") product called XIV Notes that increased in value when the market displayed low volatility as measured by the VIX Futures Index, and decreased when the market displayed high volatility by that measure.[406] Janus Index & Calculation

400. 574 F.3d 42, 45–49 (2d Cir. 2009).

401. 5 F.4th 279, 286, 290–91 & nn.29, 30 & 33, 298 (2d Cir. 2021), *cert. denied*, Korchevsky v. United States, 142 S. Ct. 761 (2022) (mem.). A jury convicted Khalupsky of conspiracy to violate the securities laws, two counts of substantive securities fraud, and one count of money laundering. *Id.* at 287.

402. *Id.* at 286.

403. *Id.* at 290.

404. *Id.* at 291.

405. *Id.* at 290–91. *Khalupsky* includes one other holding of note. The district court gave a conscious avoidance instruction: "'If you find that the defendant was aware of the high probability that the press releases were stolen, and that defendant acted with deliberate disregard of that fact, you may find the defendant acted knowingly. . . . It is entirely up to you whether you find the defendant deliberately closed his eyes." *Id.* at 296. The court found a sufficient evidentiary predicate for this instruction because "the government presented evidence that [Khalupsky] had received passwords to access the press releases on which his employees were trading. The jury would have been entitled to infer that the need for password-protection signaled to Khalupsky that the press releases—documents usually publicly disseminated without need for security—had been illicitly obtained, and that he chose not to confirm that suspicion." *Id.* at 297.

406. Set Cap. LLC v. Credit Suisse Grp. AG, 996 F.3d 64, 69 (2d Cir. 2021).

Services ("JIC") calculated a "closing indicative value" of the notes once each day, after the close of trading, "using a formula that automatically adjusted the notes' value based on the inverse of price changes observed on the VIX Futures Index."[407] During the trading day, JIC "computed an 'intraday indicative value' every 15 seconds, which was used by investors trading their notes in the secondary market."[408]

The notes had an expected long-term value of zero.[409] But holders could redeem their notes early based on a computed indicative value.[410] The notes included an acceleration provision that permitted CS to declare an Acceleration Event if, among other things, "the intraday indicative value of the XIV Notes fell such that it was less than or equal to 20 percent of the prior day's closing indicative value," and, if CS so declared, "noteholders would receive a payment based on the closing indicative value on a predetermined date no earlier than five business days after receiving notice of the acceleration."[411]

Once in each of 2011, 2015, and 2016, volatility spikes quickly and significantly raised the VIX Futures Index.[412] On each of these occasions, CS—"as well as other issuers of volatility-related ETNs[—]bought large quantities of VIX futures contracts, which were increasing in value, in order to offset or 'hedge' against potential losses in the ETNs they issued, which were decreasing in value."[413] Their purchases created a liquidity squeeze that itself raised the VIX Futures Index and lowered the price of the notes because they were inversely calibrated to that index.[414]

In July 2016, CS offered additional XIV Notes, and did so again on June 30, 2017 (adding 5 million to the then outstanding 9 million) and on January 29, 2018 (adding more than 16 million, only a portion of which were sold before February 5) so that CS "flooded the market with millions of XIV Notes just days before their value collapsed."[415] On February 5, 2018, an abrupt 4.1 percent stock market decline drove the VIX Futures Index up and the value of the XIV Notes down, and beginning at 4:09 PM, CS purchased VIX futures contracts "to hedge its exposure in sales of XIV Notes."[416] Those purchases—comprising one fourth of the market for such sales on that day—"contributed to a liquidity squeeze that caused the prices of VIX futures contracts to skyrocket," which in turn "caused the value of the XIV Notes to collapse."[417] Six minutes after CS began its VIX futures buys, its "purchases of VIX futures contracts drove down the value of XIV Notes to just over $4—a drop of more than 96 percent

407. *Id.* at 70.
408. *Id.*
409. *Id.* at 72 (disclosure in the notes' offering documents).
410. *Id.* at 70.
411. *Id.*
412. *Id.* at 70–71.
413. *Id.* at 71.
414. *Id.*
415. *Id.*
416. *Id.* at 73.
417. *Id.*

from the prior day's closing indicative value."[418] During those six minutes and for a further fifty-four minutes, JIC failed to publish an updated intraday indicative value for the notes every fifteen seconds but "updated only sporadically and valued the XIV Notes at about $24 to $27 per note (the [']Flatline Value[']),'' even though the worth of the notes during that time sat "between $4.22 and $4.40."[419] By the time JIC published the $4.22 figure, "investors [had] purchased more than $700 million in XIV Notes at inflated secondary market prices based on their incorrect belief that XIV Notes had weathered the spike in market volatility without triggering an Acceleration Event" by retaining a value above 20 percent of the prior day's closing indicative value.[420]

Since the XIV Notes had in fact on February 5 dropped to less than 20 percent of their indicative value from the day before, the events of that day constituted an Acceleration Event, which CS then declared, ultimately paying each noteholder $5.99 per note.[421]

A class consisting of those who bought XIV Notes on January 29 through February 5, 2018 sued CS and JIC and related entities, asserting that (i) CS manipulated the market for the XIV Notes and thereby violated Rule 10b-5 and Exchange Act section 9(a)—by selling millions of them into the market, knowing that, when volatility struck, its own hedging would drive the price of the notes down, permitting CS to accelerate redemption at a cheap price at a loss to noteholders and a profit to itself; (ii) CS and JIC violated Rule 10b-5 by materially misstating the Flatline Price during the critical time span on February 5; and (iii) CS violated Rule 10b-5 and Securities Act section 11 by misleading statements in the offering documents for the January 29, 2018 XIV Notes sale (the "Offering Documents").[422] Reviewing a dismissal entered by the district court that had adopted a report by a magistrate judge, the Second Circuit reversed the dismissal as to the first and third claims just listed and affirmed the dismissal as it pertained to the second.[423]

Reciting the six elements of a manipulation claim,[424] the court focused on two—whether the investors pled manipulative acts and whether they pled scienter.[425] The Second Circuit found manipulative acts pled because the investors alleged that the 2011, 2015, and 2016 events showed that CS hedging purchases in the face of increased market volatility depressed the price of the notes and, "us[ing] this knowledge as part of an undisclosed scheme to profit at their

418. *Id.*
419. *Id.*
420. *Id.*
421. *Id.* at 74. CS had sold XIV notes, during the period that the Plantiff bought, for prices up to $135. *Id.* at 73.
422. *Id.* at 72 (class period); *id.* at 74.
423. *Id.* at 75–76, 87.
424. *Id.* at 76 (quoting ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 101 (2d Cir. 2007)) ("'(1) manipulative acts; (2) damage[;] (3) caused by reliance on an assumption of an efficient market free of manipulation; (4) scienter; (5) in connection with the purchase or sale of securities; (6) furthered by the defendant's use of the mails or any facility of a national securities exchange'").
425. *Id.* at 76–82.

investors' expense," CS "exacerbated the risk of illiquidity in the VIX futures market" by offering millions of additional notes in June 2017 and January 2018, and "creat[ing] conditions in which it knew that its hedging trades would destroy the value of XIV Notes during the next volatility spike."[426] Then, when volatility struck, CS bought "more than 105,000 VIX futures contracts, caused the price of XIV Notes to plummet by more than 96 percent, and declared an Acceleration Event to lock in its profit."[427] This "[i]f proven at trial, . . . was manipulative under our precedents."[428]

As to scienter, the panel held that circuit authority permitted that element to be pled by either facts (i) "'constitut[ing] strong circumstantial evidence of conscious misbehavior or recklessness'" or (ii) "'both motive and opportunity to commit fraud.'"[429] The Second Circuit found facts raising a strong scienter inference under both theories, with that inference "at least as compelling as the competing inferences urged by [CS]."[430]

As to conscious misbehavior or recklessness, "[a] juror could reasonably infer that [CS] was aware of this dynamic [that volatility would lead to hedging that would, in turn, lead to an increase in the price of VIX futures contracts that would, in turn, depress the price of XIV Notes] . . . because the bank is a highly sophisticated financial institution and had experienced it first-hand on prior occasions."[431] The complaint alleged that, despite this knowledge, CS falsely or misleadingly stated in the Offering Documents that "its hedging activity 'could affect' the value of the VIX Futures Index while at the same time affirming that it had 'no reason to believe' that any impact would be 'material.'"[432]

426. *Id.* at 77.

427. *Id.*

428. *Id.* The panel rejected CS's argument that this could not amount to manipulation because the hedging purchases were made openly in a public market and therefore had no "'artificial' impact on the price of XIV Notes." *Id.* The court responded: "Open-market transactions that are not inherently manipulative may constitute manipulative activity when accompanied by manipulative intent." *Id.*

429. *Id.* at 78 (quoting Rombach v. Chang, 355 F.3d 164, 176 (2d Cir. 2004) (quoting Rothman v. Gregor, 220 F.3d 81, 90 (2d Cir. 2000))).

430. *Id.*

431. *Id.* After the 2016 experience, CS had announced that it would condition future XIV Note sales on counterparties' agreements "'to sell to Credit Suisse certain hedging instruments consistent with Credit Suisse's hedging strategy, including but not limited to swaps.'" *Id.* at 71. CS argued that, with this strategy in place, it "had fully hedged itself" and "would have had no need to trade VIX futures contracts at all on February 5, 2018 and therefore could not have manipulated the market for XIV Notes by doing so." *Id.* at 80. But "the complaint does not allege that Credit Suisse had 'fully' hedged its position," and did plead that CS purchased 105,000 hedging VIX futures contracts on February 5. *Id.* And the court of appeals saw the announcement that CS would insist on hedging assurances by note buyers as "reflect[ing] [CS's] awareness of the impact of its hedging strategy as well as its view that occasional spikes in market volatility would likely continue." *Id.*

432. *Id.* at 79. The court held also that "the massive economic impact of the alleged manipulation, as well as the SEC's decision to investigate Credit Suisse following the collapse of the XIV Notes, strengthen the inference that Set Capital asks us to draw," though acknowledging—in response to CS's argument that such factors could not support scienter—that "neither the SEC investigation nor the magnitude of the alleged fraud independently raises a compelling inference of manipulative intent; we view these facts principally as supporting culpable inferences drawn from stronger allegations discussed earlier." *Id.* at 79, 80.

As to motive and opportunity, "the structure of the XIV Notes, which would allow Credit Suisse to profit if the value of the notes collapsed, provided both motive and opportunity for Credit Suisse to manipulate the market," and the large offering of the notes in January 2018 "enhanced the opportunity for manipulative acts in the days leading up to the market's collapse."[433]

The Second Circuit also reversed the dismissal of the Rule 10b-5 and section 11 claims based on asserted misrepresentations in the Offering Documents. The court conceded that those documents "warned investors of extensive risks related to the purchase of XIV Notes."[434] The Offering Documents also disclosed CS's intention to hedge the exposure the notes created for it.[435] However, the court found an adequately pled deceptive half-truth in the representation that "while 'there can be no assurance that the level of the [VIX Futures] Index will not be affected [by CS hedging],' [CS] and the Individual Defendants 'have no reason to believe that [their] . . . hedging activities will have a material impact on the level of the [VIX Futures] Index.'"[436] To the contrary, the investors alleged that "following three prior volatility spikes, Credit Suisse and the Individual Defendants knew with virtual certainty that, upon the next volatility spike, their hedging activity would significantly depress the value of XIV Notes."[437] And the same allegations of scienter that sufficed for the manipulation claims sufficed for the Rule 10b-5 claims of misrepresentation in the Offering Documents.[438]

The Second Circuit, however, affirmed dismissal of the claim that CS and JIC violated the securities law by failing to correct the Flatline Price during the hour from 4:09 to 5:09 PM on February 5.[439] Here, the court found scienter allegations inadequate.[440] As to motive and opportunity, the complaint did "not identify specific evidence that [CS] profited by selling XIV Notes in the secondary

---

While CS also argued that "its hedging made it economically impossible for the bank to profit," the court accepted as true for the motion to dismiss the complaint's allegation that the CS financial report for the relevant quarter "acknowledged . . . it profited substantially from 'higher levels of volatility which benefited [its] derivatives business.'" *Id.* at 81.

433. *Id.* at 81. The court wrestled with the allegation that the CS CEO "was under significant pressure to shift Credit Suisse's investment arm away from volatile assets like XIV Notes," with CS arguing that, if this was so, "'it would have been illogical for [the CEO] and Credit Suisse to attempt to *reduce* Credit Suisse's exposure to risky assets by *increasing* its exposure to risky assets.'" *Id.* But the court allowed as to how the alleged scheme could have permitted CS to make a quick killing on the way out of this business by expanding the potential for profit, with the built-in ability to destroy the value of the XIV Notes, then eliminate the exposure they created by redeeming them through the acceleration provision. *Id.* at 81–82.

434. *Id.* at 85. These cautions included that "the notes were intended for 'sophisticated investors to manage daily trading risks' and advised purchasers that, should they hold the notes long term, 'it is likely that [they] will lose all or a substantial portion of [their] investment.'" *Id.* (alteration in original).

435. *Id.*

436. *Id.*

437. *Id.*

438. *Id.* at 86. The court found another sufficiently pled misrepresentation in the Offering Documents statement "that [CS's] hedging trades 'may present' a conflict of interest." *Id.* As the Second Circuit read the complaint, "Credit Suisse had already structured the market for XIV Notes to ensure that the next volatility spike would allow it to profit at its own investors' expense." *Id.*

439. *Id.* at 82–84.

440. *Id.* at 84.

market at prices reflecting the inflated Flatline Value . . . [or] that [CS] benefitted by delaying investors' realization that an Acceleration Event had occurred."[441] And the complaint did "not allege facts demonstrating that JIC, which was simply a 'Calculation Agent,' materially benefitted by failing to correct the Flatline Value."[442] While the investors sought to plead conscious misbehavior or recklessness, their argument rested on an alleged failure by CS and JIC "to monitor the VIX Futures Index and compare it to the values of its underlying inputs—*i.e.*, the real-time prices for VIX futures contracts."[443] But CS "was under no obligation to calculate or monitor the intraday indicative value."[444] And the Offering Documents "specified that JIC would rely on a third party, S&P, to accurately calculate the VIX Futures Index."[445]

Proxy statements. Exchange Act section 14(a) prohibits use of the mails or any means of interstate commerce to solicit proxies to vote securities registered under section 12 of that act where the proxy solicitation violates rules adopted by the SEC.[446] Rule 14a-9(a) in turn prohibits including in such solicitations false or misleading statements about any material fact and statements that mislead because the solicitation omits a material fact.[447] Aside from influencing voting at a company, a proxy statement can also affect the stock price of a merger participant before the merger closes, and those who trade in such stock may bring a Rule 10b-5 claim against the authors of a proxy statement, alleging that they acted with scienter by including falsehoods or statements that misled by omission.

In 2021, the Seventh Circuit affirmed dismissal of a section 14(a) claim based on the failure of a proxy statement to include the data underlying a discounted cash flow valuation prepared by an investment bank and included in that proxy solicitation.[448] The Second Circuit reversed dismissal of a Rule 10b-5 claim where the complaint alleged that a proxy statement misled by stating that the buyout group in a going-private merger *might* develop a plan to relist the company after the merger but the plaintiffs plausibly pleaded that the group had such a plan when the proxy statement was published.[449] The Ninth Circuit applied the Supreme Court's *Omnicare* analysis to analyze the falsity of opinions in a case based on Rule 14a-9.[450]

<u>Omission of metrics underlying valuation of target company by its financial advisor</u>. Vectren Corporation ("Vectren") merged with CenterPoint Energy, Inc.

441. *Id.* at 83.
442. *Id.*
443. *Id.* (emphasis added).
444. *Id.*
445. *Id.* at 83–84. The Offering Documents provided "that a Market Disruption Event may occur if S&P 'fails to publish or compute the [VIX Futures Index],'" and permitted CS and JIC to declare such an event. *Id.* at 84 (alteration in original). But since such a declaration was discretionary, "there can be no reasonable inference that either entity '[n]ecessarily' monitored the accuracy of the VIX Futures Index." *Id.* (alteration in original).
446. 15 U.S.C. § 78n(a) (2018).
447. 17 C.F.R. § 240.14a-9(a) (2022).
448. *See infra* notes 451–86 and accompanying text.
449. *See infra* notes 487–502 and accompanying text.
450. *See infra* notes 503–11 and accompanying text.

("CenterPoint").[451] Merrill Lynch ("ML") served as Vectren's financial advisor in the deal, contacting potential acquirors, participating in the negotiation with bidders, and providing the Vectren board with a fairness opinion for the transaction, which paid $72/share to Vectren stockholders—all in cash—constituting a 17.4 percent premium over the price of Vectren stock on the last day before public reports of a Vectren takeover.[452]

The Vectren proxy solicitation for the vote by its shareholders on the merger "summarized [ML's] fairness opinion, including three valuation analyses: one based on discounted cash flow, one using comparisons to other publicly traded companies, and a third comparing [the merger with] other similar transactions."[453] The discounted cash flow valuation computed the value of each of the three Vectren business segments, using "three discount rate ranges based on each business segment's weighted average cost of capital: (i) 5.0 to 5.8 percent for the gas utility business; (ii) 4.7 to 5.4 percent for the electric utility business; and (iii) 7.8 to 9.6 percent for the non-regulated business."[454] After deducting the net debt of the segment from the present value of the segment's future cash flow, ML added the values for the three segments together.[455] Because the value for each segment was calculated as a range between the valuation resulting from use of high and low discount rates for each one, ML then "combined the low ends of the equity value ranges for each business segment to calculate a low estimate for Vectren's implied equity value, and it combined the high ends of the equity value ranges for each business segment to calculate a high estimate."[456] The resulting valuation range for Vectren as a whole (which was what CenterPoint was buying) turned out to be between $59.00/share and $75.25/share.[457]

Seven Vectren shareholders sued to stop the merger.[458] After the district court denied a preliminary injunction, these shareholders amended their complaint to seek damages, "bas[ing their case] on the omission of two allegedly material financial metrics that they alleged rendered the Proxy Statement 'misleadingly incomplete' in violation of . . . Rule 14a-9."[459] The two metrics were: "Unlevered Cash Flow Projections, [which] showed the gross after-tax cash flow that Vectren was forecast to generate annually between 2018 and 2027" and "Business Segment Projections, [which] reflected individual financial projections for Vectren's three main business lines: gas, electric, and non-regulated (engineering and construction)."[460] In affirming dismissal of the complaint,[461] the Seventh Circuit held that the omitted metrics "were immaterial as a matter of law in light of all

451. Kuebler v. Vectren Corp., 13 F.4th 631, 634–35 (7th Cir. 2021).
452. *Id.* at 635.
453. *Id.* at 639.
454. *Id.* at 640.
455. *Id.*
456. *Id.*
457. *Id.*
458. *Id.* at 635–36.
459. *Id.* at 636.
460. *Id.*
461. *Id.* at 634, 647.

the other information disclosed in the Proxy Statement" and, for the second and independent reason that the plaintiffs "fail[ed] to allege loss causation."[462]

As to materiality, the court took into account that the proxy statement included, in addition to the summary of the ML calculations for its discounted cash flow valuation, valuations based on comparable public companies and on comparable transactions.[463] The statement also provided estimates of Vectren's net income, depreciation and amortization, EBITDA, and capital expenditures for each year from 2018 through 2027.[464] It provided as well "voluminous information about the background of the merger and its projected financial and community impacts."[465]

The summary of ML's discounted cash flow analysis stated that ML had used projected unlevered cash flow numbers for each of Vectren's business segments.[466] The complaint sought "these projections not because of any alleged error in the disclosed [ML calculations] but because plaintiffs . . . wanted to replicate Merrill Lynch's discounted cash flow analysis to make an independent determination of fair value."[467] The plaintiffs "argue[d] that the Proxy Statement could not provide a 'fair summary' of Merrill Lynch's fairness opinion without disclosing all the key inputs used by Merrill Lynch in its valuation analyses."[468] Holding that this "reaches much too far, exaggerating Vectren's disclosure obligations under Section 14(a),"[469] the Seventh Circuit said it intended by its opinion to "emphasize that shareholders are not entitled to the disclosure of every financial input used by a financial advisor so that they may double-check every aspect of both the advisor's math and its judgment."[470] Expanding, the court wrote: "Section 14(a) is not a license for shareholders to acquire all the information needed to act as a sort of super-appraiser: appraising the appraiser's appraisal after the fact."[471] Allowing as how disclosure of inputs used in financial modeling might be required in other circumstances, the panel noted that there were "no . . . allegations that the merger between CenterPoint and Vectren was marred by bad faith, disloyalty, and disregard for shareholder value."[472] Instead, "[t]he Vectren board conducted a competitive sale, and there is no plausible claim here of hidden and unappreciated value of the Vectren shares."[473]

462. *Id.* at 638, 645.

463. *Id.* at 639.

464. *Id.* at 640; Vectren Corp., Definitive Proxy Statement (DEFM14A), at 40 (July 16, 2018) [hereinafter Vectren Proxy Statement].

465. *Vectren*, 13 F.4th at 639.

466. Vectren Proxy Statement, *supra* note 464, at 37–38.

467. *Vectren*, 13 F.4th at 641.

468. *Id.*

469. *Id.*

470. *Id.* at 643–44.

471. *Id.* at 644.

472. *Id.* at 645.

473. *Id.* Solicitations of interest had identified four serious bidders by February 2018. *Id.* at 635. As one of those four, CenterPoint made a nonbinding offer to buy Vectren for $70.00/share in an all-cash transaction, which the Vectren board preferred over a cash and stock deal. *Id.* Two of the other bidders never submitted any binding offer. *Id.* After the remaining bidder submitted a $71.00/share

In the more targeted portion of its analysis, the Seventh Circuit reasoned that, given the many metrics the Proxy Statement provided, "[p]laintiffs simply have not articulated a plausible theory under which they needed disclosure of one more metric—the Unlevered Cash Flow Projections—to discover unrecognized value in their Vectren shares" and did not even "actually allege that the Consolidated Projections undervalued Vectren or that the company was worth more than the $72.00 per share paid in the merger."[474]

As for the Business Segment Projections, the court also "assume[d] that [ML] used [them] in its discounted cash flow analysis, but that fact does not automatically render them material for purposes of Section 14(a)."[475] Since CenterPoint "was offering to acquire Vectren as a whole enterprise, not in individual business segments," since "plaintiffs owned shares in Vectren as a whole enterprise . . . , not individual business segments," and since the deal on which the shareholders were voting did not give them "the option of selling separate interests in separate business lines," the complaint "failed to allege a substantial likelihood that a reasonable shareholder would have viewed the Business Segment Projections as significantly altering the total mix of available information material to whether to vote for or against the proposed merger."[476]

Turning from materiality to loss causation,[477] the Seventh Circuit read the complaint as not alleging "any actual harm," but only "that Vectren shareholders were impeded from realizing the scope of supposed economic harm."[478] One argument the plaintiffs made on value centered on "a Bloomberg chart in their amended complaint showing that Vectren's weighted average cost of capital for the first quarter of 2018 was 5.3 percent," which was below the 6.4 percent discount rate that plaintiffs calculated ML used in its discounted cash flow analysis.[479] Had the lower discount rate been used in the discounted cash flow analysis, the discounted cash flow model would have yielded a higher Vectren valuation.[480] But none of this "allege[d] plausible error with the disclosed discount rate ranges" that ML used for the different Vectren business segments,

(83 percent in cash) offer, CenterPoint submitted a binding offer at $71.50 (all to be paid in cash), which the Vectren board jawboned up to $72.00. *Id.*

474. *Id.* at 642, 643.

475. *Id.* at 641.

476. *Id.*

477. The court of appeals noted that *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 343 (2005), "held that both transaction causation and loss causation are required under Section 10(b) of the Exchange Act," but that the Supreme Court "has yet to decide whether loss causation and transaction causation must both be proved under Section 14(a)." *Id.* at 638 n.1. The panel concluded, however, that it was "persuaded by the Second and Ninth Circuits that the Court's reasoning [in *Dura*] extends to Section 14(a) claims." *Id.* (citing Wilson v. Great Am. Indus., Inc., 979 F.2d 924, 931 (2d Cir. 1992); N.Y. City Emps.' Ret. Sys. v. Jobs, 593 F.3d 1018, 1023 (9th Cir. 2010), *overruled in part on other grounds by* Lacey v. Maricopa Cnty., 693 F.3d 896 (9th Cir. 2012) (en banc)).

478. *Id.* at 646.

479. *Id.* ML used a different discount rate range for each of the three Vectren business segments. *See* text at *supra* note 454. The "unweighted mean" of the midpoints of those ranges calculated out to 6.3833 percent. *Vectren*, 13 F.4th at 646 n.5.

480. *Vectren*, 13 F.4th at 646 (plaintiffs argued that using the 6.4 percent rate "artificially deflated Vectren's value for purposes of the merger").

instead amounting only to identification of "another possible discount rate."[481] As the court saw it, the dispute over the discount rate was "a debate about the merits of the merger terms, not whether the Proxy Statement was misleading."[482]

The only other argument plaintiffs raised on valuation rested on "a 'Simply Wall Street' projection that Vectren's standalone earnings growth was projected to be 'in the teens' in the coming years."[483] The plaintiffs extrapolated from this projection that Vectren could have garnered "an inevitable superior offer."[484] The court regarded this as "only speculation," particularly given that no binding better offer than CenterPoint's was ever made.[485] Indeed, the plaintiffs failed to "even allege the existence of a viable superior offer."[486]

Significance and analysis. *Vectren's* discussion of the unlevered cash flow lays out a responsible general rule that a proxy solicitation containing summaries of valuations need not include all the inputs into the valuation models. As the panel acknowledged, particular facts could forestall application of this general rule. But if a plaintiff could make out a section 14(a) case by simply speculating that the inputs might reveal a mis-valuation, there would be no practical end to the disclosure obligation because any input would itself derive from inputs.

The failure to disclose the discounted cash flow valuation of the company's three business segments presents a more difficult issue, to which the Seventh Circuit devotes many fewer words. Providing those three numbers, which ML then summed to obtain the total company number, would have been no significant burden to Vectren. And the court's simplistic analysis—that the segment projections were immaterial because the shares the stockholders held were in the company as a whole rather than in any of the segments and that the particular deal did not offer stockholders any shares in any of those segments—could too easily be read as a rule or presumption. The court would have done well to caution that in some circumstances such disclosure could be required. This might be appropriate in a case where shareholders raised a realistic alternative to a proposed merger, with the alternative being to sell or spin out one or more of multiple segments, with information relevant to that alternative then material to a vote on a whole-company cash-out merger because shareholders might reasonably vote against that merger to encourage the board to pursue the segment sale or spinout instead. Whether such reasoning would apply should depend on particular facts, including whether the board was considering such an alternative or significant shareholders were urging it.

<u>Misrepresentation/omission regarding plan to relist following going-private transaction</u>. Qihoo 360 Technology Co. Ltd. ("Qihoo") listed ADRs on the NYSE.[487] In

481. *Id.*
482. *Id.*
483. *Id.* at 647.
484. *Id.*
485. *Id.*
486. *Id.* (citing Beck v. Dobrowski, 559 F.3d 680, 684 (7th Cir. 2009) (characterizing the *Beck* plaintiff's case as "heavy on hindsight and speculation, light on verifiable fact")).
487. Altimeo Asset Mgmt. v. Qihoo 360 Tech. Co., 19 F.4th 145, 147 (2d Cir. 2021).

May 2015, its CEO began discussing with investment bankers the possibility of taking the company private.[488] In June, the CEO presented the board with a plan to do so and, after a Special Committee of the board reviewed that proposal with the assistance of J.P. Morgan Securities (Asia Pacific) Limited, the Special Committee and the board as a whole approved a merger with a Buyer Group, the agreement for which Qihoo signed on December 18, 2015.[489] After the company distributed proxy materials, stockholders voted 99.8 percent of Qihoo shares to approve the deal, which closed on July 15, 2016, with the Qihoo shares purchased for a total of $9.4 billion.[490]

The proxy materials stated that (i) after the transaction "'the Surviving Company will become a private company'"; and (ii) "'except as set forth in this proxy statement, the Buyer Group does not have any current plans, proposals or negotiations that relate to or would result in an extraordinary corporate transaction involving the Company's corporate structure, business, or management'"; but (iii) "'subsequent to the consummation of the Merger, the Surviving Company's management and Board . . . may propose or develop plans and proposals, . . . including the possibility of relisting the Surviving Company or a substantial part of its business on another internationally recognized stock exchange.'"[491]

After the merger, Qihoo spun out its principal business into 360 Technology Co. Ltd. ("360"), which then entered into a merger, announced on November 2, 2017, with a company listed on the Shanghai Stock Exchange, 360 being the surviving company.[492] As the Second Circuit later summarized: "on February 28, 2018, the necessary asset restructuring was completed and Qihoo shares effectively began trading on the Shanghai Stock Exchange."[493] The restructured company reached a market capitalization on its first trading day of $62 billion.[494]

Two plaintiffs who "traded Qihoo securities during the period from December 2015 to June 2016" sued Qihoo, its CEO, its president, and others, alleging that they violated Rule 10b-5 because, as the court of appeals summarized it, "the Buyer Group had a plan to relist Qihoo in the Chinese capital market at the time of the [going-private] Merger."[495]

After the district court granted a defense motion to dismiss on the basis that "the complaint did not adequately plead 'that defendants, as of the Merger, had in place a concrete plan to relist Qihoo' as opposed merely 'to envisioning a possible future relisting,'" the Second Circuit vacated that dismissal.[496] The

488. *Id.*
489. *Id.*
490. *Id.* at 147–48.
491. *Id.* (alterations in original) (record citation omitted).
492. *Id.* at 148.
493. *Id.*
494. *Id.*
495. *Id.* (with plaintiffs also alleging that the defendants had provided the Buyer Group with financial projections that did not appear in the proxy materials).
496. *Id.* at 147, 149 (quoting Altimeo Asset Mgmt. v. Qihoo 360 Tech. Co., No. 19-CV-10067, 2020 WL 4734989, at *17 (S.D.N.Y. Aug. 14, 2020)); *id.* at 152.

appellate court pointed to allegations that (i) "according to '[a]n expert in Chinese and United States M&A and capitals market transactions,' it 'typically takes companies at least a full year on the quickest possible timeline, and usually longer, from the time they first start to consider a backdoor listing until they reach agreement with a shell company to conduct a reverse merger'" (contrasted with the July 15, 2016 going-private merger about sixteen months before the November 2, 2017 announcement of the reverse merger of 360 with the company listed on the Shanghai exchange) and (ii) "two news articles from 2015 . . . report[ed] that a privatization plan was provided to the Buyer Group that involved relisting the company on the Chinese stock market."[497] The Second Circuit found these "allegations create a plausible inference that a concrete plan was in place at the time Qihoo issued the Proxy Materials," so that "the statement in the Proxy Materials that 'the Buyer Group does not have any current plans' to relist Qihoo—as well as its omission of any such plan—was misleading."[498]

Significance and analysis. The Exchange Act includes two special pleading rules applicable to private Rule 10b-5 actions. One provides that the complaint "state with particularity facts giving rise to a strong inference that the defendant acted with" scienter.[499] The other requires that "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."[500] While both require the plaintiff to allege particular facts, only the first adds that the pled facts must "giv[e] rise to a *strong* inference"[501] of the required element. *Qihoo* reminds us that the particular facts pled to show that a defendant's statement was false or misleading need only be sufficient to "create a *plausible* inference."[502]

Omnicare analysis applied to section 14(a) claims. In *Virginia Bankshares, Inc. v. Sandberg*, the Supreme Court held, in a case under section 14(a) of the Exchange Act, that "statements of reasons or belief" can be "facts" for purposes of Rule 14a-9.[503] In *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, the Court held that an opinion can be false or misleading for

497. *Id.* at 150 (record citations omitted).

498. *Id.* at 150–51.

The Second Circuit also found the misstatements/omissions material. Noting a previous decision in which "information concerning merger negotiations was material even when 'negotiations had not jelled to the point where a merger was probable,'" *id.* at 151 (quoting SEC v. Shapiro, 494 F.2d 1301, 1306–07 (2d Cir. 1974)), the court of appeals found that "the appellants allege that the relisting process would have similarly required negotiations and '[r]eaching a preliminary agreement with a shell company,' [and b]ecause the relisting was announced a mere sixteen months after the Merger, the appellants allege that these negotiations were ongoing—or had already happened—at the time of the shareholder vote." *Id.* (record citation omitted). The Second Circuit could "not find those alleged negotiations 'so obviously unimportant to a reasonable investor' as to allow the dismissal of the appellants' claims." *Id.* (quoting Goldman v. Belden, 754 F.2d 1059, 1067 (2d Cir. 1985)).

499. 15 U.S.C. § 78u-4(b)(2)(A) (2018).

500. *Id.* § 78u-4(b)(1).

501. *Id.* § 78u-4(b)(2)(A) (emphasis added).

502. *Qihoo*, 19 F.4th at 151 (emphasis added).

503. 501 U.S. 1083, 1091–92 (1991).

purposes of section 11 of the Securities Act in any of three different ways.[504] First, an opinion may be false because the speaker or writer does not believe it when he or she speaks or writes the opinion.[505] Second, the opinion may be expressed in a manner that embeds in it statements of facts, and those factual representations may be false.[506] Third, the opinion may mislead because the speaker or writer does not add facts—contrary to the opinion or about the manner in which the opinion was formed—that, in context, a reasonable investor would expect to accompany the opinion.[507] The *Omnicare* decision rested this third alternative on the language of section 11 that imposes liability when a registration statement includes "an untrue statement of a material fact *or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading*."[508]

In 2021, the Ninth Circuit held that, since Rule 14a-9 contains virtually the same language as section 11, the *Omnicare* analysis applies to determine whether opinions in proxy statements are false or misleading.[509] Thus, a plaintiff may plead that an opinion in a proxy statement transgresses Rule 14a-9 by pleading that it is false or misleading in any of the three ways that *Omnicare* describes.[510]

Significance and analysis. The Ninth Circuit similarly extends the *Omnicare* analysis to opinions challenged in Rule 10b-5 claims, based on the similarity of the language in that rule to the language in section 11.[511] All of this seems correct.

SEC procedure. In a 9-to-7 en banc decision, the Fifth Circuit held that a respondent in an SEC administrative enforcement proceeding could sue in federal district court to enjoin that proceeding on the basis that the ALJ conducting it was unconstitutionally insulated from removal by the President.[512] The Second Circuit held that (i) the five-year limitations period applicable to Commission actions for civil penalties could be extended by a tolling agreement because that limitation was not jurisdictional; and (ii) a district court decision to use the number of victims to determine the number of "violations" the defendant committed for purposes of computing the civil penalty cap in 15 U.S.C. § 77t(d) did not abuse the discretion the lower court possessed in computing that limit.[513]

504. 575 U.S. 175 (2015). Section 14(a) lies at 15 U.S.C. § 78n (2018), and Rule 14a-9 at 17 C.F.R. § 240.14a-9 (2022).

505. *Omnicare*, 575 U.S. at 184.

506. *Id.* at 185.

507. *Id.* at 186–91.

508. 15 U.S.C. § 77k(a) (2018); *Omnicare*, 575 U.S. at 189.

509. Golub v. Gigamon Inc., 994 F.3d 1102 (9th Cir. 2021).

510. *Id.* at 1106–07; *see id.* at 1107 ("*Omnicare's* elucidation of what 'facts' a statement of opinion may convey and the possibility and manner of proving those 'facts' false or misleading through an omission theory applies to the Rule 14a-9 context."). The published *Golub* decision summarized in the text dealt only with the legal issue of applying *Omnicare* in a Rule 14a-9 case. An accompanying memorandum opinion affirmed the district court decision dismissing the complaint. Golub v. Gigamon, Inc., 847 F. App'x 368 (9th Cir. 2021).

511. *Id.* at 1107 (citing City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc., 856 F.3d 605, 616 (9th Cir. 2017)).

512. *See infra* notes 514–28 and accompanying text.

513. *See infra* notes 529–48 and accompanying text.

Federal court jurisdiction to enjoin SEC administrative proceedings before those proceedings conclude. Faced with an administrative enforcement proceeding alleging that she violated Public Company Accounting Oversight Board ("PCAOB") auditing standards, Michelle Cochran filed a lawsuit in federal district court asserting that, "because SEC ALJs [('Administrative Law Judges')] enjoy multiple layers of 'for-cause' removal protection, they are unconstitutionally insulated from the President's Article II removal power."[514] After the district court dismissed for want of jurisdiction, a Fifth Circuit panel affirmed.[515] In 2021, the circuit took up the jurisdictional issue en banc and reversed the district court by a 9-to-7 vote.[516]

The majority turned first to the words of 28 U.S.C. § 1331, giving district courts "original jurisdiction of *all* civil actions arising under the Constitution, laws, or treaties of the United States."[517] Acknowledging that "Congress can limit district court jurisdiction if it so chooses," the majority then turned to 15 U.S.C. § 78y(a)(1), providing that "[a] person aggrieved by a final order of the [SEC] . . . may obtain review of the order in the United States Court of Appeals . . . by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part."[518]

The nine-judge opinion rejected, for three reasons, the SEC position that, "[b]y giving *some* jurisdiction to the courts of appeals . . . , Congress implicitly stripped *all* jurisdiction from every other court—including district courts' jurisdiction . . . under § 1331."[519] First, since § 78y(a)(1) applies only to persons "'aggrieved by a final [SEC] order,'" it "says nothing about people, like Cochran, who have not yet received a final order of the Commission" or "people, again like Cochran, who have claims that have nothing to do with any final order that the Commission might one day issue."[520] Second, by using the word "may," § 78y(a)(1) is permissive, and "[i]t would be troublingly counterintuitive to interpret [that] permissive language as eliminating alternative routes to federal court review, especially in the context of separation-of-powers claims of the sort at issue here."[521] Third, § 78y(a)(3) provides that the court of appeals' jurisdiction "becomes exclusive" "on the filing of [(i)] the petition" and (ii) the

514. Cochran v. SEC, 20 F.4th 194, 198 (5th Cir. 2021), *petition for cert. docketed*, No. 21-1239 (Mar. 11, 2022).

515. Cochran v. SEC, 969 F.3d 507, 511–18 (5th Cir. 2020).

516. *Cochran*, 20 F.4th at 198, 213, 236. In addition to her argument that the ALJ's insulation from executive removal contravened the Article II provision mandating that the President "take Care that the Laws be faithfully executed," U.S. Const. art. II, § 3, cl. 1, Cochran claimed that the enforcement proceeding violated her due process rights. *Cochran*, 20 F.4th at 198. But that claim, insofar as it pertained to the jurisdiction of the district court to enjoin the administrative proceeding, had dropped out after the panel decision. *Id.* at 199.

517. *Cochran*, 20 F.4th at 199 (quoting part of 28 U.S.C. § 1331, with the majority also italicizing the word italicized in the text).

518. *Id.* at 200 (quoting this statute).

519. *Id.*

520. *Id.*

521. *Id.* at 200–01.

underlying record, neither of which had happened yet here—"show[ing] that Congress knew how to strip jurisdiction when it wanted to—and . . . highlight[ing] that Congress did not strip § 1331 jurisdiction elsewhere."[522]

Significance and analysis. The seven-judge dissent argued that "every court of appeals to consider the question has answered that a person facing an SEC enforcement action may not mount a collateral attack against the agency proceeding in federal district court."[523] *Cochran* now creates a circuit split on this issue, and the SEC has sought certiorari review by the Supreme Court.[524]

In addition to the majority opinion and the dissent, six of the nine judges comprising the majority filed an extraordinary concurrence.[525] It took as its theme that the entire SEC enforcement scheme derived from (i) the animosity toward democracy displayed by Woodrow Wilson and his "acolyte" James Landis, "the SEC's founding father [who] drafted § 78y into the original Securities Exchange Act"[526] and (ii) their conviction that technical experts should govern

522. 15 U.S.C. § 78y(a)(3) (2018); *Cochran*, 20 F.4th at 201.

The majority added that *Free Enterprise Fund v. Public Co. Accounting Oversight Board*, 561 U.S. 477 (2010), supported this decision. *Cochran*, 20 F.4th at 201–04. They also included an analysis of the three factors that *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200 (1994), identified "to determine whether Congress implicitly precluded initial judicial review by creating a statutory framework that delegates initial review to an administrative agency." *Id.* at 204–12. "First, Cochran's removal power claim is wholly collateral to the Exchange Act's statutory-review scheme" because "[t]he nature of her challenge is structural—it does not depend on the validity of any substantive aspect of the Exchange Act, nor of any SEC rule, regulation, or order." *Id.* at 207. "Second, Cochran's claim is outside the SEC's expertise" because it "does not depend on a special understanding of the securities industry." *Id.* at 207–08. "Third, the Exchange Act's statutory-review scheme threatens to deprive Cochran of the opportunity for meaningful judicial review" "because the enforcement proceedings will not necessarily result in a final adverse order [which] is a prerequisite for judicial review under § 78y(a)(1)." *Id.* at 208–09.

The majority also held that Cochran's claim was ripe, reasoning that (i) "[t]here is no dispute that Cochran's removal power claim is a pure issue of law, meaning that it is fit for judicial decision without any additional fact-finding" and (ii) "if Cochran's claim is meritorious, then withholding judicial consideration would injure her by forcing her to litigate before an ALJ who is unconstitutionally insulated from presidential control." *Id.* at 212–13.

523. *Cochran*, 20 F.4th at 236 (9-7 decision) (Costa, J., dissenting) (citing Bennett v. SEC, 844 F.3d 174 (4th Cir. 2016); Hill v. SEC, 825 F.3d 1236 (11th Cir. 2016); Tilton v. SEC, 824 F.3d 276 (2d Cir. 2016); Jarkesy v. SEC, 803 F.3d 9 (D.C. Cir. 2015); Bebo v. SEC, 799 F.3d 765 (7th Cir. 2015); *see also* Axon Enter., Inc. v. FTC, 986 F.3d 1173 (9th Cir. 2021), *cert. granted in part*, 142 S. Ct. 895 (2022) (mem)). The dissenters viewed the text of 15 U.S.C. § 78y, as well as the "structure of the SEC enforcement scheme," to create "an exclusive review scheme that bypasses district courts." *Id.* at 237–38. They distinguished *Free Enterprise* on the basis that it "involved an accounting firm that regulators were investigating but had not yet charged." *Id.* at 244. As for the three *Thunder Basin* factors, the dissenters (i) argued that "section 78y provides a meaningful avenue of relief for people like Cochran . . . who are 'embroiled in an enforcement proceeding' and can appeal an adverse agency order," *id.* at 246 (quoting Bank of La. v. FDIC, 919 F.3d 916, 927 (5th Cir. 2019)); (ii) concluded that Cochran's "removal power claim may not be" "wholly collateral to the section 78y scheme" because "Cochran would not be able to assert this claim but for the SEC's charging her in an enforcement proceeding"; and (iii) reasoned that her claim was not outside SEC expertise because "agency expertise should . . . be assessed by looking at the overall case, so this factor accounts for the possibility that the agency's resolution of other issues 'may obviate the need to address the constitutional challenge.'" *Id.* at 246–48.

524. *See supra* note 514.

525. *Id.* at 213–36.

526. *Id.* at 214.

in matters such as securities regulation without interference by courts.[527] All this was relevant, the concurrence posited, to "underscore our conclusion that the words in § 78y enacted by Congress—as opposed to the unenacted purposes that motivated Landis—do not strip jurisdiction over Cochran's removal claim."[528]

Limitation on civil penalty action. Under current law, the SEC must bring a claim for a civil penalty within the five-year period in 28 U.S.C. § 2462.[529] The Commission must bring a claim for an injunction, or a bar, suspension, cease-and-desist order, or other equitable remedy, within the ten-year period in 15 U.S.C. § 78u(d)(8)(B).[530] Per 15 U.S.C. § 78u(d)(8)(A), the SEC must file a claim for disgorgement within five years, unless the underlying violation requires the SEC to prove scienter, in which case the period extends to ten years.[531]

In *SEC v. Fowler*, the Second Circuit addressed whether tolling agreements can extend the § 2462 five-year limit.[532] The Commission filed its lawsuit on January 9, 2017, alleging that Fowler (a registered representative of a broker) had violated Rule 10b-5 and Securities Act section 17 by "recommend[ing] to customers a 'high-cost, in-and-out trading strategy without having a reasonable basis for believing that this strategy was suitable for anyone,'" while he "'knew or recklessly disregarded that the strategy . . . was bound to lose money,'" and "made 'little or no mention of fees and costs' that he knew would erase any gains."[533] Since the complaint claimed that Fowler's scheme began in 2011, the five-year limitations period would have expired in 2016.[534] But Fowler and the Commission made two agreements to extend that deadline, ultimately until February 9, 2017.[535] Thus, the Commission filed its complaint outside the five-year statutory period but within the extension.

After a jury found for the Commission on all causes of action, the district court entered a permanent injunction forbidding Fowler from violating securities laws, ordered disgorgement of $132,076.40, and imposed a $1,950,000 civil penalty.[536] Affirming, the Second Circuit rejected Fowler's contention that the § 2462 time limit was jurisdictional and therefore beyond the parties' power to enlarge.[537] Beginning with the general rule that "[w]ithout 'a clear statement, . . . courts should treat [statutes of limitations] as nonjurisdictional'" "'even when [they are] framed in mandatory terms . . . however emphatic[ally] expressed those terms may be,'" the court found the statute's language ("an action . . . shall not be entertained

527. *Id.* at 214–15, 221.
528. *Id.* at 225.
529. 28 U.S.C. § 2462 (2018) (running "from the date when the claim first accrued").
530. 15 U.S.C. § 78u(d)(8)(B) (2018) (running from "the latest date on which a violation that gives rise to the claim occurs").
531. *Id.* § 78u(d)(8)(A) (running from "the latest date of the violation that gives rise to the action or proceeding in which the Commission seeks the claim occurs").
532. 6 F.4th 255 (2d Cir. 2021), *cert. denied*, 142 S. Ct. 590 (2021) (mem.).
533. *Id.* at 258, 259 (quoting amended complaint).
534. *Id.* at 260.
535. *Id.*
536. *Id.*
537. *Id.*

unless commenced within five years from the date when the claim first accrued") "does not itself tell us that Congress intended § 2462 to be jurisdictional."[538]

In one other important holding, the Second Circuit addressed Fowler's challenge to the amount of the civil penalty the court ordered him to pay.[539] The Securities Act civil penalty provision defines three levels of such penalties and sets limits on the penalties that can be ordered for each.[540] First-tier penalties—applicable to any transgression of the Act or accompanying regulations—could not exceed (at the time Fowler committed his fraud), for "each violation," "the greater of" (i) $7,500 for a natural person or $75,000 for any entity, or (ii) "the gross amount of pecuniary gain to such defendant as a result of the violation."[541] Second-tier penalties—applicable to such a violation if it "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement"—could not exceed, for "each such violation," the greater of $75,000 (natural person) or $375,000 (entity), on the one hand, or the gross pecuniary gain on the other.[542] Third-tier penalties—applicable if the violation involved fraud, deceit, etc. *and* "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons"—could not exceed, for "each such violation," the greater of $150,000 (natural person) or $725,000 (entity), on the one hand, or the gross pecuniary gain on the other.[543]

As the quoted words highlight, a key determinant of each limit is the number of "violations" the Commission can prove. In any fraud scheme running for a period of time and involving fraud on a number of different victims, it is possible to parse the facts in ways that increase or decrease the number of "violations" and therefore increase or decrease the limit on the total civil penalties the court can order. The district court in *Fowler* determined that the facts supported third-tier penalties against Fowler and multiplied the third-tier natural person limit of $150,000 times the thirteen customers Fowler defrauded—thereby counting each customer as a separate "violation"—to arrive at a total limit of $1,950,000, which was the civil penalty amount that the court ordered Fowler to pay.[544] Fowler argued

538. *Id.* at 261 (quoting United States v. Wong, 575 U.S. 402, 409–10 (2015)). The panel also rejected the argument that the 1948 change in the statute—from "[n]o suit . . . shall be maintained" to "an [enforcement] action . . . shall not be entertained"—demonstrated a congressional intent to convert § 2462 into a jurisdictional restriction. *Id.* at 261–62 (noting that the "Reviser's Notes to § 2462 contained in the House Committee report confirm[ed] that the '[c]hanges were made in phraseology' only. H.R. Rep. 80-308 . . . , at A191 (1947).").

539. *Id.* at 264–67.

540. 15 U.S.C. § 77t(d)(2) (2018).

541. *Id.* § 77t(d)(2)(A). The Commission adjusts the amounts periodically for inflation. The court states that the applicable limit for Fowler was $150,000. *Fowler*, 6 F.4th at 264. The amounts applicable to Fowler's wrongdoing are found in the table at 17 C.F.R. § 201.1001 tbl.I, showing $150,000 for a natural person limit under 15 U.S.C. § 78u for the column headed Mar. 4, 2009–Mar. 5, 2013. Accordingly, that column supplies all the numbers in the text. *See also* SEC v. Fowler, 440 F. Supp. 3d 284, 298 n.4 (S.D.N.Y. 2020) (showing that the district court used this column because "the period from March 4, 2009 to March 5, 2013 . . . embraces most of the period at issue here").

542. 15 U.S.C. § 77t(d)(2)(B) (2018); 17 C.F.R. § 201.1001 tbl.I (2022).

543. 15 U.S.C. § 77t(d)(2)(C) (2018); 17 C.F.R. § 201.1001 tbl.I (2022).

544. *Fowler*, 6 F.4th at 260 (amount ordered); *id.* at 264 (district court calculation).

that, since the SEC contended that he orchestrated a single scheme, he committed only one "violation" for purposes of the civil penalty limit.[545]

The Second Circuit acknowledged that "[t]he term 'violation' is not defined by the statutory scheme," referred generally to the district court's "'broad equitable power to fashion appropriate remedies,'" and concluded that it would review the district court's decision to view each customer as a "violation" only for abuse of discretion.[546] Since the lower court had explained that "'Fowler selected his victims . . . individually,'" that counting "'each of his defrauded customers as a separate violation best effectuates the purposes of the statute,'" and "that a per-trade penalty 'would be so substantial' that Fowler would not 'reasonably be capable' of paying it," the panel concluded that it would "not second-guess the District Court's discretionary decision to resort to a per-customer unit of violation to determine the civil penalty in this case."[547]

Significance and analysis. *Fowler* leaves to the discretion of the district court the degree to which that court parses a set of facts to find the number of violations. *Fowler* also employs an abuse of discretion standard to review that number. Since the limit on civil penalties depends critically on the number of violations, this gives trial courts enormous discretion over the limit to the penalties it imposes. Such wide discretion seems inconsistent with the carefully calibrated limits to civil penalties in 15 U.S.C. § 77t(d)(2)—with three different tiers, dual limits within each (highest of either set dollar amount times number of violations or gross amount of pecuniary gain to the defendant) and periodic adjustments to the set dollar amounts.[548]

Criminal cases. The four defendants in *United States v. Harra* had served as executives at Wilmington Trust Company ("Wilmington"), with one of them (Gibson) as the CFO.[549] A jury convicted them of one count of conspiracy to commit

545. *Id.* at 265.

546. *Id.* at 264, 265 (quoting first the district court, then quoting SEC v. Sourlis, 851 F.3d 139, 146 (2d Cir. 2016)).

547. *Id.* In one other ruling of note, the Second Circuit rejected the argument that the government should have proceeded with a churning claim rather than a suitability claim. *Id.* at 262–63.

548. In other decisions addressing SEC enforcement procedures, the Second Circuit found no abuse of discretion where a district court enforced a subpoena directed to a defendant who had previously entered into a proffer agreement with the SEC. SEC v. O'Brien, 842 F. App'x 652, 653–54 (2d Cir. 2021), *cert. denied*, 142 S. Ct. 103 (2021) (mem.). The Ninth Circuit affirmed a preliminary injunction freezing all the assets of defendants in the remand of the 2020 *Liu* decision by the Supreme Court. SEC v. Liu, 851 F. App'x 665, 667 (9th Cir. 2021). The district court then fixed the disgorgement amount. SEC v. Liu, Case No. SACV 16-00974-CJC (AGRx), 2021 WL 2374248 (C.D. Cal. June 7, 2021), *appeal filed*, No. 21-56090 (9th Cir. Oct. 6, 2021). The Fifth Circuit held that a plan by which the SEC would act as a trustee for the victims and would disburse the gains only after approval by the district court satisfied the *Liu* decision's concern that disgorgement proceeds be returned to victims. SEC v. Blackburn, 15 F.4th 676, 681–82 (5th Cir. 2021) (caveating that the court did "not hold that this scheme is the only way to satisfy *Liu* as other cases may present greater challenges for ensuring that disgorgement benefits victims"). The D.C. Circuit found that a respondent in a FINRA disciplinary proceeding forfeited constitutional arguments by failing to raise them when challenging the FINRA disciplinary order before the SEC. Springsteen-Abbott v. SEC, 989 F.3d 4, 7–9 (D.C. Cir. 2021).

549. 985 F.3d 196, 204 (3d Cir. 2021); Brief for Appellant David Gibson and Jt. App'x Vol. 1 of 25, United States v. Harra, 985 F.3d 196 (3d Cir. 2021) (No. 19-1136), 2019 WL 3776206, at *9.

fraud against the U.S. government or an agency thereof under 18 U.S.C. § 371, one count of securities fraud under 18 U.S.C. § 1348, fourteen counts of making false statements to the SEC and the Federal Reserve under 18 U.S.C. § 1001 and 15 U.S.C. § 78m, and three counts (against Gibson only) of falsely certifying periodic reports submitted to the SEC under 18 U.S.C. § 1350.[550]

The case revolved around loans, primarily for building construction, that required debtors to make monthly interest payments until maturity, whereupon the debtor had to pay "'all outstanding principal plus all accrued unpaid interest.'"[551] The loans also provided that Wilmington could "'renew or extend (repeatedly and for any length of time) [the] loan . . . without the consent of or notice to anyone.'"[552] Until July 2010, Wilmington did not, internally, consider such a loan as past due when the debtor was current on interest payments and Wilmington was in the process of renewing the loan (the "Waiver Practice").[553] In 2009, debtors on something like $300 million of such loans could not pay their principal on maturity, and Wilmington reacted by approving mass extensions of such loans.[554] Wilmington did not identify these loans as past due in reports filed with the SEC, the Federal Reserve (the "Fed"), or the Office of Thrift Supervision ("OTS").[555]

In February 2010, Wilmington sold stock by offering documents that "did not reflect the loans that would have matured but for the mass extensions" and "told prospective investors the Bank's past-due loan liability was even lower at the end of 2009 than the prior year."[556] In July of that year, however, Wilmington "changed its waiver practice, resolving that '[a]ll matured/current loans' would be 'reported in [the] Past Due numbers.'"[557] By the end of 2010, the Fed had "issued a 'troubled condition' letter," and Wilmington had merged with M&T Bank.[558]

Reversing all but the convictions on the securities count and the conspiracy to commit securities fraud,[559] the Third Circuit concluded that "[e]very offense with which Defendants were charged involved the alleged falsity of the Bank's reporting of 'past due' loans."[560] The "Defendants advanced a theory throughout the trial that their statements were not actually false because the SEC's and Federal Reserve's reporting instructions were ambiguous and, under an objectively reasonable interpretation of those instructions, Defendants were not required to report the waived loans as 'past due.'"[561]

The Third Circuit agreed that the reporting requirements were ambiguous. Though none of the agencies defined "past due," each of them referred to contract

550. *Harra*, 985 F.3d at 207.
551. *Id.* at 204–05.
552. *Id.* at 205.
553. *Id.*
554. *Id.*
555. *Id.* at 205–06.
556. *Id.* at 223.
557. *Id.* at 205 (alteration in original).
558. *Id.*
559. *Id.* at 204, 225.
560. *Id.* at 207 (quoting government brief).
561. *Id.*

terms in discussing the past due reporting obligation, with the Fed and OTS adding that the past due status of a loan was not affected by "grace periods."[562] The OTS issued guidance through a Q&A document that responded to "a situation—akin to the Bank's waiver practice—where 'construction loans that require interest-only payments due monthly with the principal due at maturity' were past maturity but current on interest" by saying that: "'If management has restructured or extended a loan—formally or informally[—]*then the loan would not be past due*.'"[563] That guidance continued by defining "[a]n informal extension" to occur "'when the bank has agreed to accept interest payments until the property is rented or sold.'" If "'[t]he extension [is] for a limited and reasonable length of time[,]'" and if therefore, "'[f]rom the borrower's perspective, . . . he is doing what the bank has told him, the loan is not in default and does not have to be reported.'"[564]

Since Wilmington had by contract "preserved [its] right to 'renew or extend (repeatedly and for any length of time) th[e] loan . . . without the consent of or notice to anyone,'" thereby "giving the Bank a contractual right to, of its own accord, determine that a payment due under the contract is not due at all" and since Wilmington had "exercised this right—by making arrangements with borrowers to 'waive' the loan—whether the principal payment remained 'contractually past due' is ambiguous to say the least."[565] Nor was the ambiguity removed by two examples in the guidance from the Fed and OTS:

> Single payment and demand notes, debt securities, and other assets providing for the payment of interest at stated intervals are to be reported as past due after one interest payment is due and unpaid for 30 days or more.
>
> Single payment notes, debt securities, and other assets providing for the payment of interest at maturity are to be reported as past due after maturity if interest or principal remains unpaid for 30 days or more.[566]

"[N]either of these circumstances clearly applies to loans—like those at issue here—that require interest to be paid both at regular intervals and at maturity. *See* A11755 (providing for the payment of both regular monthly payments and the payment of 'all accrued unpaid interest' upon maturity)."[567]

Given the uncertainty of the reporting requirements and that the government had to prove that the defendants were responsible for submitting *false* reports, the court then wrestled with how the prosecution could "prove falsity in the face of [this] ambiguous reporting requirement."[568] The court of appeals rejected the government position that conviction should follow if the United States "prove[d] that a defendant understood an ambiguous reporting requirement to

562. *Id.* at 205–06.
563. *Id.* at 206 (emphasis by the court).
564. *Id.*
565. *Id.* at 218–19.
566. *Id.* at 206, 219 (numeration excluded from block quotes).
567. *Id.* at 219.
568. *Id.* at 209. The panel found this to be a question of first impression in the Third Circuit. *Id.* at 209–11.

mean what the Government says it means and, in light of that meaning, intended to lie" because that view improperly "collapses *subjective falsity*—the defendant's intent to lie—with *objective falsity*, *i.e.*, the untruth of the statement in question."[569] The Third Circuit held, instead, that since "potential defendants [must] be given 'fair warning' of what conduct could give rise to criminal liability," "where falsity turns on how an agency has communicated its reporting requirements to the entities it regulates and those communications are ambiguous, fair warning demands that the Government prove a defendant's statement false under each objectively reasonable interpretation of the relevant requirements."[570]

In this case, therefore, "the Government bore the burden of proving beyond a reasonable doubt that either the alternative interpretation [of the reporting regulations offered by the defendants] was unreasonable or that Defendants' statements were false even under that alternative and reasonable interpretation."[571] It was "quite plausible—given the terms of the loan agreements here—that the phrase 'contractually past due' would exclude a mature loan that is treated as 'waived' and that is in the process of being extended, even when no notice has been given [to] the borrower."[572] And, "other than relying on the purported 'ordinary meaning' of 'contractually past due,' the Government offer[ed] no evidence that this interpretation is *unreasonable*."[573] Accordingly, the prosecution had not carried "its burden to prove falsity."[574]

For the court, that disposed of the case insofar as it rested on reports to the SEC.[575] The only complication raised by the Fed and OTS reporting arose from the examples quoted above, but the prosecution failed to show that "the *only* reasonable interpretation" of them was one that made the Wilmington reports false.[576] Since the government concededly failed to prove that the defendants' interpretation of the reporting requirements was either unreasonable or that the reports were false under that interpretation, the prosecution had failed to prove falsity as to the reports to the Fed and OTS as well.[577]

This failure was "fatal" to all the counts except the conspiracy to commit securities fraud and substantive securities fraud.[578] The Third Circuit therefore remanded "for the entry of judgments of acquittal" on the "false statement and certification convictions."[579]

569. *Id.* at 211 (emphasis added).

570. *Id.* at 212–13 (with quotations from each of these pages). As a corollary, if the government proves "that its interpretation is the only objectively reasonable interpretation and that, under this interpretation, the defendant's statement was false," then the prosecution prevails on the falsity element. *Id.* at 215.

The court added that ambiguity could also be relevant to the scienter element. *Id.*

571. *Id.* at 219–20.

572. *Id.* at 220.

573. *Id.*

574. *Id.*

575. *Id.*

576. *Id.* (emphasis by the court).

577. *Id.*

578. *Id.* at 220–21.

579. *Id.* at 225.

As to the counts charging conspiracy to commit securities fraud and substantive securities fraud, the panel concluded that the government's case blended both the theory that the Wilmington reports were false and the theory that the mass extensions of the loans were designed to keep them off the books while Wilmington prepared documents for the February 2010 offering.[580] For this reason, even though "a rational juror could conclude that Defendants had knowingly caused maturing loans to be extended in order to push them off the books for 2009 and conceal the poor financial health of the Bank from investors, and that they had knowingly joined an agreement to do so," the use—in proving the securities counts—of the evidence argued to support the "legally invalid" theory of the false reporting and the circumstance that the lower court wove that theory into the instructions forbade a finding that those instructions were harmless error with respect to the securities counts.[581] The panel therefore vacated the convictions for conspiracy and securities fraud and remanded for a new trial on those counts.[582]

Significance and analysis. Although rendered in a criminal case, the Third Circuit commented that "[e]ven in the civil context, fair warning requires that government agencies communicate their interpretation of their own regulations with 'ascertainable certainty' before subjecting private parties to punishment under that interpretation."[583] The requirement that the government must prove that a statement is false under each of all reasonable interpretations of an ambiguous reporting requirement may therefore apply in civil enforcement proceedings as well. But in the securities context, defendants may find its application limited. The SEC provides massive support to practitioners explaining the many SEC rules. Even more importantly, many securities statutes are phrased so that a statement that is literally true can impose liability if it is misleading.[584]

Additional cases. The D.C. Circuit declined to review an SEC order—requiring participants in existing Data Equity Sharing Plans to submit a new plan with specific features—on the ground that the order was not a final one because the new plan itself, including the specific features, would be subject to SEC consideration and approval or modification after public comment.[585] That same court held—in determining when the sixty-day period for filing a petition for review begins to

580. *Id.* at 222–23 (explaining the securities fraud mass extension theory); *id.* at 224 (showing how the prosecution conjoined the theories).

581. *Id.* at 223–25.

582. *Id.* at 225.

583. *Id.* at 213.

584. *See*, *e.g.*, Rule 10b-5(b), making it unlawful "to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading," 17 C.F.R. §§ 240.10b-5. *See also* 17 C.F.R. § 240.12b-20 (2022); Securities Act §§ 11(a), 12(a)(2), 15 U.S.C. § 77k(a), 77*l*(a)(2) (2018); Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a) (2022).

In a second noteworthy opinion in a criminal case, the Second Circuit reversed Federal Rule of Criminal Procedure Rule 29 and Rule 33 orders in a case where the prosecution centered on defendants consenting to an indenture amendment, even though the indenture prohibited affiliates of the issuer from voting on amendments, and the defendants directed consent to the amendment by issuer-affiliated entities. United States v. Landesman, 17 F.4th 298 (2d Cir. 2021).

585. Nasdaq Stock Mkt. LLC v. SEC, 1 F.4th 34 (D.C. Cir. 2021).

run—that an SEC action styled as an "order" will be treated, regardless of its "substance or the procedure used to effectuate it," as an order rather than a rule so that a petition must be filed within sixty days of the order's *entry*.[586]

Addressing claims under the California state securities law but applying principles from federal securities law, the Ninth Circuit affirmed dismissal of claims against Uber Technologies, Inc. ("Uber"), concluding that the plaintiffs failed to plead loss causation where the complaint alleged some sixty misstatements relating to multiple scandals that came to light over a period of many months and where the plaintiff's own chart showed that, after several of the damaging facts came to light, valuations of the issuer's stock (held by funds, as Uber was at this time still privately held) increased, with the court finding that the complaint relied on a year-long decline in the valuations rather than linking particular valuation declines to specific misstatements and corrective disclosures.[587]

The Tenth Circuit affirmed a defense judgment after a bench trial on claims that advisor fees violated Investment Company Act section 36(b).[588]

Addressing a case in which the issuer filed a registration statement for a direct secondary offering on the NYSE by some shareholders and in which other shareholders offered their securities on the NYSE on the basis of the Securities Act section 4(a)(2) exemption, the Ninth Circuit held that purchasers of *all* those shares could sue under Securities Act sections 11 and 12(a)(2).[589]

The First Circuit affirmed summary judgment for a defendant, applying section 29(b) of the Exchange Act and refusing to enforce a contract providing for a success fee for sale of a company where the defendant had assigned the engagement to an affiliate that was not a registered broker, the confidential information memorandum for the sale of the client company expressly referenced the possibility of an equity transaction as an alternative to an asset sale, and the client company's equity consisted of LLC interests that might have been classified as securities.[590]

The Second Circuit found a transaction was not "domestic" under *Morrison v. National Australia Bank Ltd.*, even though it was reported to the TRACE system developed by FINRA[591] and found a transaction in another case—in which a Bermudan investor bought preferred stock in a private placement by a Bermudan issuer—not "domestic" by applying that circuit's *Parkcentral Global* exception to the place-of-irrevocable-commitment test.[592] The First Circuit adopted that place-of-irrevocable-commitment standard, but not the *Parkcentral Global* exception.[593]

586. N.Y. Stock Exch. LLC v. SEC, 2 F.4th 989, 993 (D.C. Cir. 2021).

587. Irving Firemen's Relief & Ret. Fund v. Uber Techs., Inc., 998 F.3d 397, 402, 405, 407–08 (9th Cir. 2021).

588. Obeslo v. Great-West Life & Annuity Ins. Co., 6 F.4th 1135 (10th Cir. 2021).

589. Pirani v. Slack Techs., Inc., 13 F.4th 940, 944 (9th Cir. 2021).

590. EdgePoint Cap. Holdings, LLC v. Apothecare Pharmacy, LLC, 6 F.4th 50, 53–56, 60 (1st Cir. 2021).

591. Banco Safra S.A.-Cayman Islands Branch v. Samarco Mineracao S.A., 849 F. App'x 289, 295 (2d Cir. 2021).

592. Cavello Bay Reinsurance Ltd. v. Shubin Stein, 986 F.3d 161, 163–64, 168 (2d Cir. 2021).

593. SEC v. Morrone, 997 F.3d 52, 59–60 (1st Cir. 2021).

The Eighth Circuit held that SLUSA precluded breach of contract and negligence class action claims against a broker based on delays in reinvesting the proceeds from automatically triggered tax loss sales.[594] The Ninth Circuit found that SLUSA did not preclude a class action for breach of fiduciary duty where the plaintiff alleged that a broker—without conducting suitability analyses—had offered accounts charging an annual fee based on asset values to customers holding accounts charging trade-by-trade commissions.[595]

The Eighth Circuit reversed certification of a class where the plaintiff alleged that a broker violated its duty of best execution by routing trades in a manner designed to maximize its own profits instead of to obtain the best prices for brokerage clients, holding that economic loss would have to be determined by factors affecting individual class members.[596]

The Eleventh Circuit held equitable tolling applies to the requirement that a Securities Act section 12(a)(1) claim must be brought within "one year after the violation upon which it is based," but affirmed dismissal because the plaintiff had possessed, since acquisition, all the facts determining that the tokens he purchased were investment contracts and therefore securities.[597] The Third Circuit held that *American Pipe* tolling applies where a putative class member files an individual action before the court handling the putative class action decides the certification motion.[598]

The Eighth Circuit found personal jurisdiction and venue proper in federal district court in Fargo, North Dakota, where Singapore citizens sued a Singapore resident on Securities Act claims and the defendant had marketed interests in a North Dakota limited liability company, received commissions from North Dakota, and traveled to North Dakota to sell the investments, taking pictures and videos during those trips to show that the company was conducting operations.[599]

594. Knowles v. TD Ameritrade Holding Corp., 2 F.4th 751, 755–57 (8th Cir. 2021).

595. Anderson v. Edward D. Jones & Co., 990 F.3d 692, 696 (9th Cir. 2021), *cert. denied*, 142 S. Ct. 745 (2022) (mem.).

596. Ford v. TD Ameritrade Holding Corp., 995 F.3d 616, 623 (8th Cir. 2021).

597. Fedance v. Harris, 1 F.4th 1278 (11th Cir. 2021).

598. Aly v. Valeant Pharms. Int'l Inc., 1 F.4th 168, 169, 170–71 (3d Cir. 2021).

599. Kaliannan v. Liang, 2 F.4th 727, 733–36 (8th Cir. 2021), *cert. denied*, 142 S. Ct. 758 (2022) (mem.).