Annual Review of Federal Securities Regulation

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

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Introduction

This Annual Review ("Review") was prepared by the Subcommittee on Annual Review of Federal Securities Regulation ("Subcommittee") of the ABA Business Law Section's Committee on Federal Regulation of Securities. The Review is a survey of significant developments in federal securities laws and regulations, as well as developments relating to accounting pronouncements and securities

litigation matters, in 2022. The Review is divided into three sections: regulatory actions, accounting statements, and caselaw developments.

The Review is prepared by and for securities practitioners and securities litigators. 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.

The U.S. Securities and Exchange Commission (the "Commission" or "SEC") proposed thirty-five rules relating to such matters as enhancing investor protections in initial public offerings by special purpose acquisition companies, requiring registrants to provide certain climate-related information in their registration statements and annual reports, and standardizing disclosures regarding cybersecurity risk management. However, during 2022, there were only seventeen final regulations adopted by the Commission.

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 concepts as well as factual background. While the Subcommittee tries to avoid making editorial comments regarding regulations, rules, or cases, we attempt 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 2022

A. Insider Trading Arrangements and Related Disclosures

On December 14, 2022, the Commission unanimously adopted amendments to Rule 10b5-1 under the Securities Exchange Act of 1934 (the "Exchange Act") and related disclosure obligations for public companies.[1] The amendments (i) add new conditions to the availability of the affirmative defense to insider trading liability contained in Rule 10b5-1 designed to address concerns about the rule's abuse by insiders to trade securities on the basis of material nonpublic information ("MNPI") and (ii) enhance public disclosure by issuers and insiders of trading plans designed to comply with Rule 10b5-1.[2]

1. Background

Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder prohibit purchases or sales of a security on the basis of MNPI about that security or the issuer, in breach of a duty owed to such issuer or the shareholders of such issuer or to any person who is the source of that MNPI.[3] This prohibited conduct is more commonly referred to as "insider trading." Rule 10b5-1 provides an affirmative defense to insider trading liability for trades undertaken pursuant to a binding contract, an instruction to another person to execute the trade for the instructing person's account or a written plan (collectively, a "10b5-1 Plan") adopted when the trader was not aware of MNPI.[4] 10b5-1 Plans must be entered into in good faith and not as part of a scheme to evade the prohibitions of insider trading rules.[5]

Since adoption of Rule 10b5-1 in 2000, the Commission, courts, members of Congress, academics, and others have grown increasingly concerned that Rule 10b5-1 has allowed traders to escape liability by trading on the basis of MNPI while still technically satisfying the Rule's requirements. In order to address these concerns, the Commission issued a proposal a little over a year ago consistent with prior statements made by Commission Chair Gary Gensler, as well as recommendations made to the Commission by its Investor Advisory Committee,

1. *See* Insider Trading Arrangements and Related Disclosures, 87 Fed. Reg. 80362 (Dec. 29, 2022) (to be codified at 17 C.F.R. pts. 229, 232, 240 & 249).
2. *Id.* at 80362.
3. *Id.* at 80363.
4. *Id.*
5. *Id.* at 80365.

with respect to 10b5-1 Plans.[6] The proposal included new conditions to the availability of the Rule 10b5-1 affirmative defense, such as cooling-off periods between adoption of a 10b5-1 Plan and the first trade thereunder, limitations on multiple overlapping 10b5-1 Plans, and limits on single-trade 10b5-1 Plans, as well as new disclosure requirements.[7] The Commission received over 180 comment letters regarding the proposed amendments.

2. Amendments to Rule 10b5-1

Cooling-Off Periods for Directors and Officers. Prior to the effective date of the amendments, Rule 10b5-1 did not require any waiting or "cooling-off" periods between the date on which a 10b5-1 Plan is adopted and the date of the first transaction made pursuant to such plan, although some plans voluntarily included, and some companies required, such a cooling-off period.[8] Under the amendments, in order to qualify for the affirmative defense provided by Rule 10b5-1:

- Trading under a 10b5-1 Plan adopted by a director or "officer," as defined in Rule 16a-1(f), must not begin until the later of (1) ninety days following plan adoption or "modification" (as described below) and (2) two business days following disclosure of the issuer's financial results for the fiscal quarter in which the plan was adopted or modified (but not to exceed 120 days following plan adoption or modification); and
- Trading under a 10b5-1 Plan for persons other than issuers or directors and officers (which includes non-officer employees who enter into 10b5-1 Plans) must not begin until thirty days following plan adoption or modification.[9]

For purposes of the director and officer cooling-off period, the amendments provide that an issuer will be considered to have disclosed its financial results at the time it files a quarterly report on Form 10-Q or an annual report on Form 10-K, or, in the case of foreign private issuers (FPIs), when such FPIs file a Form 20-F or furnish a Form 6-K that discloses financial results.[10]

In an important change from the proposal, issuers are not subject to a cooling-off period.[11] The amendments clarify that a "modification" of an existing 10b5-1 Plan would be deemed to be a termination of such 10b5-1 Plan and would restart the applicable cooling-off period.[12] The amendments provide that "any modification or change" to the amount, price, or timing of the purchase or

6. *See generally* Rule 10b5-1 and Insider Trading, 87 Fed. Reg. 8686 (proposed Feb. 15, 2022) (to be codified at 17 C.F.R. pts. 229, 232, 240 & 249).

7. *Id.*

8. Insider Trading Arrangements and Related Disclosures, *supra* note 1, at 80371.

9. *Id.* at 80401.

10. *Id.* at 80370.

11. *Id.* at 80371–72.

12. *Id.* at 80405.

sale of the securities underlying a 10b5-1 Plan is treated as a termination of the plan and the adoption of a new plan.[13] To the extent that insiders seek to continue to rely on the affirmative defense, they would be subject to a new cooling-off period.[14] Additionally, cancellation of one or more trades would constitute a "modification."[15] However, modifications that do not change the sales or purchase prices or price ranges, the amount of securities to be sold or purchased, or the timing of transactions under a 10b5-1 Plan (such as an adjustment for stock splits or a change in account information) will not trigger a new cooling-off period.[16] The amendments do not provide any de minimis modification exception. In other words, a modification need not be "material" in order for it to trigger a new cooling-off period.

Director and Officer Certifications. Under the amendments, at the time a 10b5-1 Plan is adopted (or modified), directors and officers are required to include a representation in the 10b5-1 Plan certifying they (i) are not aware of MNPI about the issuer or its securities and (ii) are adopting (or modifying) the 10b5-1 Plan in good faith and not as part of a scheme to evade the prohibitions of the Exchange Act's section 10(b) or Rule 10b-5.[17] In a change from the proposal, and to eliminate any additional burden separate documentation may create, directors and officers are required to include the certification in the plan documents as representations rather than as a separate certification to the issuer.[18] The final rules do not require directors and officers to retain the certification for ten years, as was originally proposed, although it is prudent for them to maintain accurate records, including the representations, to establish they have satisfied the conditions of the affirmative defense.[19]

Prohibition on Overlapping 10b5-1 Plans and Limits on Single-Trade 10b5-1 Plans. The amendments eliminate Rule 10b5-1's affirmative defense for trades by any trader other than the issuer (i.e., beyond directors and officers) who establishes multiple overlapping 10b5-1 Plans.[20] The proposal had included issuers within this prohibition, and it is a significant change that issuers are not subject to this aspect of the amendments.

The amendments provide a few limited exceptions to the multiple overlapping plan prohibition. To address an insider's use of multiple brokers to execute trades pursuant to a single 10b5-1 Plan that covers securities held in different accounts, the amendments treat a series of formally distinct contracts with different broker-dealers or other agents as a single "plan," if taken together, the contracts otherwise satisfy the applicable conditions of Rule 10b5-1.[21] In addition, the amendments provide that a broker-dealer or other agent executing trades on

13. *Id.*
14. *Id.*
15. *Id.* at 80367.
16. *Id.* at 80371.
17. *Id.* at 80373.
18. *Id.* at 80405.
19. *Id.*
20. *Id.* at 80405–06.
21. *Id.* at 80406.

behalf of the insider pursuant to the 10b5-1 Plan may be substituted by a different broker-dealer or other agent as long as the purchase or sales instructions applicable to the substituted broker and the substitute are identical, including with respect to the prices of securities to be purchased or sold, the dates of the purchases or sales to be executed, and the amount of securities to be purchased or sold.[22] This means an insider will not lose the benefit of the affirmative defense when closing a securities account with a financial institution and transferring the securities to a different financial institution. An insider also may maintain two separate Rule 10b5-1 Plans at the same time, so long as trading under the later-commencing plan is not authorized to begin until after all trades under the earlier-commencing plan are completed or expire without execution, subject to compliance with applicable cooling-off period requirements.[23]

The amendments also authorize certain "sell-to-cover" transactions in which an insider instructs its agent to sell securities in order to satisfy tax-withholding obligations at the time an award vests so the insider will not lose the benefit of the affirmative defense with respect to an otherwise eligible 10b5-1 Plan if the insider has another plan in place that would qualify for the affirmative defense, so long as the additional plan or plans only authorize qualified sell-to-cover transactions.[24] A plan authorizing sell-to-cover transactions qualifies for the new provision if the plan authorizes an agent to sell only such securities as are necessary to satisfy tax-withholding obligations incident to the vesting of a compensatory award, such as restricted stock or stock appreciation rights, and the insider does not otherwise exercise control over the timing of such sales.[25]

Transactions with the issuer not executed on the open market, such as employee stock purchase plans ("ESPPs") or dividend reinvestment plans ("DRIPs"), would be excluded from the prohibition on overlapping plans.[26]

The amendments also limit the availability of the affirmative defense by persons other than the issuer to one "single-trade" 10b5-1 Plan during any twelve-month period.[27]

Acting in Good Faith. Rule 10b5-1 previously required that 10b5-1 Plans be entered into in good faith and not as part of a plan or scheme to evade the insider trading rules.[28] In order to clarify that cancellations or modifications of a 10b5-1 Plan may not be conducted in a manner to benefit from MNPI, the amendments require that 10b5-1 Plans be entered into in good faith and the person who has entered into the plan must act in good faith throughout the duration of the trading arrangement.[29]

22. *Id.* at 80377.
23. *Id.*
24. *Id.* at 80378.
25. *Id.*
26. *Id.* at 80375.
27. *Id.*
28. *Id.* at 80373.
29. *Id.* at 80379.

The adopting release explains that good faith, with respect to trading under a 10b5-1 Plan, applies to activities within the insider's control.[30] For example, an insider would not be operating a 10b5-1 Plan in good faith if the insider, while aware of MNPI, directly or indirectly induces the issuer to publicly disclose that information in a manner that makes their trades under a 10b5-1 Plan more profitable (or less unprofitable). On the other hand, the adopting release indicates that trading suspensions directed by the issuer, which are outside the control or influence of the insider, such as an issuer-imposed trading halt due to a possible merger, may not, by themselves, implicate the good-faith condition.

3. New Disclosure Requirement for Public Companies and Insiders

Public Company Disclosures. Prior to the effective date of the amendments, there were no disclosure requirements concerning the adoption, termination, or use of 10b5-1 Plans by issuers or insiders, and issuers were not required to disclose their insider trading policies or procedures.[31] The amendments add a new Item 408 to Regulation S-K and make certain amendments to Forms 10-Q, 10-K, and 20-F.[32]

Public companies using domestic reporting forms (e.g., Forms 10-Q and 10-K) will be required to provide quarterly disclosure of the adoption or termination of 10b5-1 Plans and other trading arrangements for directors and officers.[33] In a significant change, as adopted, Item 408's disclosure requirements apply only to an issuer's directors' and officers' 10b5-1 Plans and not to the issuer's.[34]

Disclosures must include the material terms of the 10b5-1 Plan or other arrangement, such as the name and title of the director or officer, adoption or termination date, the duration of the 10b5-1 Plan or arrangement, the aggregate number of securities to be sold or purchased pursuant to the 10b5-1 Plan or arrangement, and whether the arrangement is intended to satisfy the requirements for use of Rule 10b5-1's affirmative defense.[35] However, the disclosure is not required to include the pricing terms of the trading arrangement.[36]

Public companies will also be required to disclose whether they have adopted insider trading policies and procedures reasonably designed to promote compliance with the insider trading laws.[37] Companies that have adopted insider trading policies and procedures will be required to file such policies and procedures as an exhibit to their annual report on Form 10-K or 20-F.[38] If a company has not adopted such policies and procedures, it will be required to disclose why it

30. *Id.* at 80380.
31. *Id.*
32. *Id.* at 80381.
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.* at 80382.
37. *Id.* at 80384–85.
38. *Id.* at 80385.

has not done so.[39] Public companies that use domestic reporting forms would be required to make these disclosures annually in their annual reports on Form 10-K, and FPIs would similarly be required to include this information in their annual Form 20-F filings.[40]

The amendments also create new obligations for executive compensation disclosure. Specifically, new tabular disclosures are required that identify, for each director and named executive officer ("NEO"), (i) each award of stock options, SARs, or similar option-like instruments (i.e., the grant date, the number of securities underlying the award, exercise price of the award, and the grant date fair value of the award) granted during a period starting four business days before, and ending one business day after, the filing of a periodic report on Form 10-Q or Form 10-K or the filing or furnishing of a current report on Form 8-K that discloses MNPI (other than a Form 8-K disclosing a material new option award grant); (ii) the market value of the underlying securities the trading day before disclosure of the MNPI; and (iii) the market value of the underlying securities one trading day after disclosure of MNPI.[41]

The table format is as follows:

Name	**Grant date**	**Number of securities underlying the award**	**Exercise price of the award ($/Sh)**	**Grant date fair value of the award**	**Percentage change in the closing market price of the securities underlying the award between the trading day ending immediately prior to the disclosure of material nonpublic information and the trading day beginning immediately following the disclosure of material nonpublic information**
PEO					
PFO					
A					
B					
C					

In addition to the tabular disclosures, the amendments require narrative disclosure about the company's option grant policies and practices regarding the timing of option grants and the release of MNPI, including how the board determines when to grant options and whether, and if so, how, the board or compensation committee takes MNPI into account when determining the timing and

39. *Id.*
40. *Id.*
41. *Id.* at 80389–90.

terms of an award.[42] This disclosure is required to be included in annual reports on Form 10-K and proxy and information statements related to the election of directors, approval of compensation plans, or solicitations of advisory votes to approve executive compensation.[43] Unlike some other executive compensation disclosure, emerging growth companies and smaller reporting companies ("SRCs") are not exempt from these disclosure requirements.[44]

Insider Obligations Under Section 16 of the Exchange Act. Persons reporting transactions on a Form 4 or Form 5 pursuant to section 16 under the Exchange Act will be required to identify whether the reported transaction was executed pursuant to a plan "intended to satisfy the affirmative defense conditions" of Rule 10b5-1 by checking a new checkbox on Form 4 and Form 5.[45]

Relatedly, the amendments require that bona fide gifts of securities, whether or not part of a 10b5-1 Plan, be reported on a Form 4 by the end of the second business day following the gift.[46] Currently, these transactions are reportable on a Form 5, which is filed once a year within forty-five days after the issuer's fiscal year end.[47]

Inline XBRL. The amendments require public companies to tag the narrative disclosures, as well as quantitative amounts within the narrative disclosures, in Inline XBRL, in accordance with Rule 405 of Regulation S-T and the EDGAR Filer Manual.[48]

Effective Date and Phase-in Period. The amendments became effective February 27, 2023.[49] Public companies, other than SRCs, must comply with the disclosure and Inline XBRL tagging requirements in Forms 10-Q, 10-K, and 20-F, and any proxy or information statements required to include the Item 408 and/or Item 402(x) disclosures, beginning with the first such filing covering the first full fiscal period beginning on or after April 1, 2023.[50] SRCs will be required to provide and tag the disclosures after an additional six-month transition period or in the first filing covering the first full fiscal period beginning on or after October 1, 2023.[51] This means that annual reports on Form 10-K and 20-F for the year ended December 31, 2022, will not need to include the disclosures required by Items 408 and 402(x). Likewise, proxy statements that contain Part III information for such annual reports on Form 10-K will not need to include these disclosures. Section 16–reporting persons will be required to comply with the amendments to Forms 4 and 5 for beneficial ownership reports filed on or after April 1, 2023.[52]

42. *Id.*
43. *Id.*
44. *Id.* at 80388.
45. *Id.* at 80387.
46. *Id.* at 80392.
47. *Id.* at 80391.
48. *Id.*
49. *Id.* at 80362.
50. *Id.* at 80393.
51. *Id.*
52. *Id.*

B. Pay Versus Performance

On August 25, 2022, the Commission finally adopted a "pay versus performance" rule in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") mandate that requires SEC–reporting companies to disclose in a clear manner the relationship between executive compensation actually paid and the company's financial performance.[53] As adopted, the rule generally requires disclosure of five years of pay versus performance data in proxy and information statements in which executive compensation information is required to be included pursuant to Item 402 of SEC Regulation S-K.[54] The new pay versus performance disclosures must be included in proxy and information statements that are required to include such compensation information for fiscal years that ended on or after December 16, 2022.[55]

1. Background

The Dodd-Frank Act added section 14(i) to the Exchange Act, directing the Commission to adopt a pay versus performance rule in proxy and information statements in which executive compensation information is required to be included pursuant to Item 402 of Regulation S-K.[56] The Commission originally proposed the pay versus performance rule in 2015 ("2015 Proposal"), proposing new subsection (v) to Item 402 of Regulation S-K to require a new compensation table, showing the relationship between compensation actually paid to NEOs and a company's performance, with performance measured both by the company's total shareholder return ("TSR") and peer group TSR, as well as a description of the relationship of pay to performance.[57] In early 2022, the Commission reopened the comment period on the 2015 Proposal (as opposed to re-proposing its pay versus performance rule) and requested comments on additional disclosures that were not contemplated in the 2015 Proposal.

2. Requirements of Pay Versus Performance Rule

As adopted, new Item 402(v) of Regulation S-K requires:

- a new pay versus performance table,

53. *See* Pay Versus Performance, 87 Fed. Reg. 55134 (Sept. 8, 2022) (to be codified at 17 C.F.R. pt. 229, 232 & 240).
54. *Id.* at 55136.
55. *Id.* at 55161.
56. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 953(a), 124 Stat. 1376, 1903.
57. Pay Versus Performance, *supra* note 53, at 55135.

- a clear description of the relationship between the compensation actually paid to the principal executive officer ("PEO") and to the other NEOs ("Remaining NEOs") and the company's performance across each of the measures included in the pay versus performance table, which may be presented as a narrative, a graph, or a combination of the two, and
- a tabular list of the most important financial performance measures that the company uses to link NEO compensation to company performance.[58]

Companies have flexibility as to the exact placement of the pay versus performance disclosures within the proxy or information statement, although these must appear with, and in the same format as, the rest of the executive compensation disclosures required to be provided by Item 402 of Regulation S-K. The disclosures may, but need not, be part of the Compensation Discussion and Analysis.[59]

Pay Versus Performance Table. The pay versus performance table must disclose the compensation paid to the PEO and the average compensation paid to the Remaining NEOs as compared to four performance measures.[60] The performance measures required to be included are:

- company TSR,
- peer group TSR,
- net income, and
- a company-selected financial performance measure ("Company-Selected Measure").[61]

The new table must contain data for five years, except that SRCs are permitted to provide three years of data.[62]

58. *Id.* at 55136–37.
59. *Id.* at 55137.
60. *Id.* at 55136.
61. *Id.*
62. *Id.* at 55161.

Pay Versus Performance

Year	Summary Compensation Table Total For PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for non-PEO Named Executive Officers	Average Compensation Actually Paid to non-PEO Named Executive Officers	Value of Initial Fixed $100 Investment Based on:		Net Income*	[Company -Selected Measure]*
					Total Shareholder Return	Peer Group Total Shareholder Return*		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Y1								
Y2								
Y3								
Y4*								
Y5*								

*Denotes disclosures not required for SRCs

Description of Pay Versus Performance Relationship. The required tabular disclosure must be accompanied by a clear description of the relationship between

- both executive compensation actually paid to the PEO and the average compensation actually paid to the Remaining NEOs, and each of the following:
  - the company TSR,
  - company net income, and
  - the Company-Selected Measure; and
- the Company's TSR and the peer group TSR.[63]

If a company elects to provide any additional measures in the table, each additional measure must be accompanied by a clear description of the relationship between such compensation actually paid and the additional measure over the company's five fiscal years displayed in the table.[64] The descriptions can be provided in narrative or graphic form, or a combination of both.[65] For example, the adopting release indicates that the relationship could be expressed as a graph providing executive compensation actually paid and change in financial performance measure(s) on parallel axes and plotting compensation and the measure(s) over the required time period.[66] Companies are permitted to group the descriptions, but any combined description of multiple relationships must be clear.[67]

Companies may supplement the required disclosure with additional pay versus performance measures or descriptions (in the table or elsewhere).[68] However, any such supplemental disclosure must be clearly identified as supplemental, not be misleading, and not be presented more prominently than the required disclosure.[69]

Tabular List. Additionally, companies (other than SRCs) must provide an unranked list of the three to seven most important financial performance measures used to link executive compensation actually paid to NEOs during the last fiscal year with the company's performance.[70] Alternatively, companies may elect to include one tabular list for the PEO and one list for the Remaining NEOs, or provide lists for each NEO, setting out the applicable three to seven financial performance measures used to link the relevant individual's compensation with company performance.[71] Companies are permitted to include non-financial

63. *Id.* at 55137.
64. *Id.*
65. *Id.* at 55155.
66. *Id.* at 55141.
67. *Id.* at 55137.
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.*

measures in the list if they consider such measures to be among their three to seven most important measures.[72] If a company uses fewer than three measures to link NEOs' compensation to company performance, only measures actually used must be included.[73]

3. Additional Information

Companies Covered. The pay versus performance rule applies to all SEC–reporting companies, except FPIs, registered investment companies, and emerging growth companies.[74] Business development companies (a category of closed-end investment company) and SRCs are subject to the rule, although the disclosure requirements for SRCs are scaled.[75]

Filings Covered. As previously noted, pay versus performance disclosure is required in proxy and information statements that are required to contain executive compensation disclosure pursuant to Item 402 of Regulation S-K.[76] The pay versus performance information will not be deemed to be incorporated by reference into any filing under the U.S. Securities Act of 1933, as amended (the "Securities Act"), or the Exchange Act unless the company specifically incorporates it.[77]

Executives Covered. The pay versus performance table must separately provide compensation information for the PEO, on an annual basis, for each of the past five fiscal years (three in the case of SRCs).[78] If more than one person has served as PEO in any year, data for each PEO must be reported in separate columns.[79]

In addition, the table must provide average (i.e., mean) compensation, on an annual basis, for the Remaining NEOs for such years.[80] The Remaining NEOs whose compensation amounts are included in the averages reported for a given year must be individually identified by a footnote.[81] The footnote will allow investors to consider the average compensation reported with changes in composition of the Remaining NEOs.[82]

Pay Covered. The elements of the compensation actually paid category reflects that information contained in the Summary Compensation Table is distinct from the compensation paid to an NEO in a given year.[83] Under Item 402(v)(2) of Regulation S-K, compensation actually paid to each individual is comprised of total compensation disclosed in the Summary Compensation

72. *Id.* at 55159.
73. *Id.* at 55157.
74. *Id.* at 55137.
75. *Id.*
76. *Id.* at 55161.
77. *Id.* at 55137.
78. *Id.* at 55143.
79. *Id.*
80. *Id.*
81. *Id.* at 55140.
82. *Id.*
83. *Id.* at 55143.

Table modified to adjust the amounts included for pension benefits, equity awards, and above-market or preferential earnings on deferred compensation that is not tax-qualified, each as described below.[84]

For each year included in the pay versus performance table, companies will be required to deduct from the Summary Compensation Table total the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans, and add back the aggregate of: (i) actuarially determined service cost for services rendered by the NEO during the applicable year (service cost); and (ii) the entire cost of benefits granted in a plan amendment (or initiation) during the covered fiscal year that are attributed by the benefit formula to services rendered in periods prior to the plan amendment or initiation (prior service cost), in each case, calculated in accordance with U.S. generally accepted accounting principles ("GAAP").[85] The change in actuarial present value would be deducted only if the value is positive. The scaled disclosure requirements do not require SRCs to make this pension adjustment.[86]

The 2015 Proposal had proposed to treat equity awards as actually paid in the fiscal year in which such awards became vested.[87] However, comments to the 2015 Proposal noted that such timing could create a perceived misalignment between pay and performance since such awards would be viewed as actually paid only in the year of vesting rather than actually paid in each fiscal year over the life of the award between the date of grant and the date of vesting.[88] For example, where an award vests over a three-year period and the company's financial performance is positive in the first two years and negative in the third, reporting the full value of the award only in the vesting year may give investors the misleading impression that the executive was not rewarded for positive performance in years one and two, and was rewarded despite negative performance in year three. To address these concerns, Item 402(v) of Regulation S-K, as adopted, generally requires that equity awards first be reported as compensation actually paid in the fiscal year during which the award is granted based on the fair value as of the last day of the year, and then, in each subsequent year, changes in the fair value of the award as of the last day of the fiscal year will be reported until a final fair value is reported for the fiscal year in which vesting occurs (i.e., the date that all applicable vesting conditions have been satisfied) determined as of the date of vesting.[89] For any awards that are subject to performance conditions, the change in fair value is calculated based on the probable outcome of such conditions as of the last day of the fiscal year.

84. *Id.*
85. *Id.* at 55145.
86. *Id.*
87. *See* Pay Versus Performance, 80 Fed. Reg. 26329 (proposed May 7, 2015) (to be codified at 17 C.F.R. pts. 229 & 240).
88. *See generally Comments on Proposed Rule: Pay Versus Performance*, U.S. Sec. & Exchange Commission (Aug. 25, 2022), https://www.sec.gov/comments/s7-07-15/s70715.htm.
89. Pay Versus Performance, *supra* note 53, at 55148–49.

Specifically, to calculate compensation actually paid for equity awards for each year included in the pay versus performance table, companies need to deduct the equity award amounts shown in the Summary Compensation Table from total compensation and then add or subtract the following amounts, as applicable:

- the year-end fair value of any equity awards granted in the covered fiscal year that are outstanding and unvested as of the end of the covered fiscal year;
- the amount of change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value of any awards granted in prior years that are outstanding and unvested as of the end of the covered fiscal year;
- for awards that are granted and vest in the same covered fiscal year, the fair value as of the vesting date;
- for awards granted in prior years that vest in the covered fiscal year, the amount equal to the change in fair value as of the vesting date (from the end of the prior fiscal year);
- for awards granted in prior years that are determined to fail to meet the applicable vesting conditions during the covered fiscal year, a deduction for the amount equal to the fair value at the end of the prior fiscal year; and
- the dollar value of any dividends or other earnings paid on stock or option awards in the covered fiscal year prior to the vesting date that are not otherwise reflected in the fair value of such award or included in any other component of total compensation for the covered fiscal year.[90]

Vesting date valuation assumptions have to be disclosed by footnote if they are materially different from those disclosed as of the grant date.[91]

Additionally, compensation actually paid must include above-market or preferential earnings on deferred compensation that is not tax-qualified. Such amounts may be viewed to approximate the value that would be set aside currently by the company to satisfy its obligations in the future. Such amounts of deferred compensation that are not tax-qualified must be included, whether or not such amounts are vested and whether or not such amounts are actually paid during such year.[92] According to the Commission, "excluding those amounts until their eventual payout would make the amount 'actually paid' contingent on an NEO's choice to withdraw or take a distribution from their account . . . . The Commission does not believe such treatment would accurately represent compensation 'actually paid.'"[93]

90. *Id.* at 55149.
91. *Id.* at 55150.
92. *Id.* at 55146.
93. *Id.*

The pay versus performance table also must disclose, in an accompanying footnote, the amounts of compensation deducted from, and added to, the Summary Compensation Table total compensation in determining compensation actually paid to the PEO and Remaining NEOs.[94]

Finally, any one-time payment, such as a signing or severance bonus, must be included in compensation actually paid.[95] While such amounts may not be reflective of what an executive typically receives in a year, they are amounts that were actually paid in that year.

Measures of Performance. Company TSR and peer group TSR must be included as performance measures in the pay versus performance table, calculated in accordance with Item 201(e) of Regulation S-K, by "dividing the (i) sum of (A) the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and (B) the difference between the company's share price at the end and the beginning of the measurement period; by (ii) the share price at the beginning of the measurement period."[96] Both company and peer group TSR are calculated based on a fixed $100 investment.[97] The peer group TSR presented in the table must be weighted according to the respective issuers' market capitalization at the beginning of the relevant period.[98] The peer group must be identified by footnote or such identification may be incorporated by reference from prior Commission filings, unless the peer group is a published industry or line of business index.[99] Additional disclosures are required any time the company modifies the peer group used for TSR.[100] SRCs do not need to provide peer group TSR.[101]

In addition, the final rule requires companies to include net income for each year included in the pay versus performance table.[102]

The last column included in the pay versus performance table sets out the Company-Selected Measure, which must be a numerically quantifiable financial performance metric.[103] The Company-Selected Measure must be the most important financial performance measure used to determine NEO compensation not already included in the pay versus performance table in the company's view.[104] The Company-Selected Measure can change from year to year.[105]

Non-GAAP Financial Measures. The Company-Selected Measure, or additional measures included in the pay versus performance table, are permitted to be non-GAAP financial measures.[106] Any disclosure of a non-GAAP financial

94. *Id.* at 55140.
95. *Id.* at 55143.
96. *Id.* at 55136.
97. *Id.* at 55154.
98. *Id.* at 55153.
99. *Id.*
100. *Id.*
101. *Id.*
102. *Id.* at 55154.
103. *Id.* at 55159.
104. *Id.*
105. *Id.* at 55160.
106. *Id.*

measure that a company elects to provide as part of its pay versus performance disclosure will not be subject to Regulation G or Item 10(e) of Regulation S-K.[107] However, the company must provide disclosure as to how the number is calculated from its audited financial statements.[108]

XBRL. The pay versus performance table, footnotes, and related disclosures all must be separately tagged using Inline XBRL.[109] The footnotes and description of the relationship may be tagged using block-text tags, while individual data points must be separately tagged.[110]

Phase-In. The general phase-in for the rule requires pay versus performance disclosure for three years in the first proxy or information statement in which such disclosure is required for all companies, other than SRCs, for fiscal years that ended on or after December 16, 2022.[111] In each of the two subsequent years, another year of disclosure would be added. SRCs only need to provide information for two years for the first filing requiring such disclosure for fiscal years that ended on or after December 16, 2022, with a third year added in their next annual proxy or information statement that requires executive compensation disclosure.[112] Also, SRCs will not have to comply with the XBRL requirement until the third annual filing containing pay versus performance disclosure.[113]

A newly reporting company does not need to include pay versus performance information for fiscal years prior to their first completed fiscal year as a reporting company.[114]

C. Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers

On November 2, 2022, by a vote of three-to-two, the Commission adopted rule and form amendments to expand the information that mutual funds, closed-end funds, exchange-traded funds, and other registered investment companies must disclose about their proxy votes.[115] Additionally, any institutional investment manager that files Form 13F will be required to file Form N-PX to begin reporting proxy votes for the first time, but limited to say-on-pay votes.[116] The adopted rules are largely in line with the proposal from September 2021, with a few notable exceptions.

107. *Id.*
108. *Id.*
109. *Id.* at 55141.
110. *Id.*
111. *Id.* at 55134.
112. *Id.* at 55160.
113. *Id.*
114. *Id.*
115. Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, Securities Act Release No. 11131, 87 Fed. Reg. 78770 (Nov. 2, 2022), https://www.sec.gov/rules/final/2022/33-11131.pdf.
116. *Id.* at 78772 (discussing the scope of managers' Form N-PX reporting obligations).

Among other things, the amendments will require funds to categorize voting matters, structure and tag the data reported, and tie the description of each voting matter to the issuer's form of proxy. The Commission said that it believes the amendments will make these proxy voting records more user-friendly by improving investors' ability to monitor how funds and managers vote and compare their voting records, thereby increasing transparency.[117]

1. Amendments to Form N-PX

Say-on-Pay Disclosures—Applies to Registered Funds and 13F Filers, Generally. The amendments will require any institutional investment manager required to file Form 13F also to report annually its say-on-pay votes on Form N-PX.[118] The types of say-on-pay votes that managers must report include (1) votes "on the approval of executive compensation," (2) votes "on the frequency of such executive compensation approval votes," and (3) votes "to approve 'golden parachute' compensation in connection with a merger or acquisition."[119]

An institutional investment manager will be required to report the say-on-pay votes only for a security over which the manager exercised its voting power to influence a voting decision for the security, either directly or indirectly.[120] Voting power includes the ability to determine whether to vote the security, or to recall a security on loan before a vote.[121]

The amendments focus on whether a manager uses its own independent judgment to influence a vote. Thus, the manager will have no reporting obligation when the client or another party determines how to vote a proxy.[122] Additionally, multiple parties could both have and exercise voting power over the same

117. Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules to Enhance Proxy Voting Disclosure by Registered Investment Funds and Require Disclosure of "Say-on-Pay" Votes for Institutional Investment Managers (Nov. 2, 2022), https://www.sec.gov/news/press-release/2022-198.

118. *See* Enhanced Reporting of Proxy Votes, *supra* note 115, at 78817 (Item 1 of amended Form N-PX), 78772 (discussing the scope of managers' Form N-PX reporting obligations). An "institutional investment manager" is defined for this purpose as any person, other than a natural person, investing for its own account or having investment discretion over $100 million or more in section 13(f) securities. It is important to recognize that the definition of an institutional investment manager is broader than some assume, as it does not require management of a securities portfolio on behalf of clients or customers. For example, corporations managing their own pension plans can be institutional investment managers. Say-on-pay votes are nonbinding shareholder advisory votes on executive compensation matters for public companies pursuant to section 14A of the Exchange Act. The reporting obligations here are consistent with the reporting obligations under section 14A(d) of the Exchange Act.

119. *Id.* at 78772 (discussing the scope of managers' Form N-PX reporting obligations); *see* Exchange Act § 14A(a)–(b), 15 U.S.C. § 78n-1 (2018). Note that managers will not be required to report shareholder votes on executive compensation that are not required to be reported by section 14A(a) or section 14A(b) of the Exchange Act.

120. *See* 17 C.F.R. § 240.14Ad-1(d)(1)–(2) (2022); Enhanced Reporting of Proxy Votes, *supra* note 115, at 78773 (discussing managers' exercise of voting power).

121. Enhanced Reporting of Proxy Votes, *supra* note 115, at 78773 (discussing managers' exercise of voting power).

122. *Id.*

securities. The Commission believes the new requirements will balance investor informational needs, reporting burdens, and statutory obligations.[123]

Importantly, in contrast to the proposed amendments,[124] the final rule limits the reporting obligations for managers who have a disclosed policy of not voting proxies and in fact have not voted during the reporting period.[125] Managers will be required only to disclose that policy in a notice report on Form N-PX without providing additional information about each security individually.[126]

Although the new reporting obligations apply only to institutional investment managers that are also reporting persons for the purposes of Form 13F, the scope of securities reported on Form 13F deviates significantly from the scope of securities with respect to which a manager is required to report under the new Form N-PX reporting obligations. For example:

- Form 13F's *de minimis* exemption for small holdings does not apply to Form N-PX.[127]
- Form N-PX will require every institutional investment manager that files Form 13F to report how it voted on any say-on-pay shareholder vote, which may include say-on-pay votes held by issuers of securities that are not reported on Form 13F.
- Form N-PX reporting obligations are not limited to the requirements of Form 13F when a manager only reports votes for securities held at quarter-end, and there is no specific holding period requirement for Form N-PX reporting obligations to apply.[128]

The amendments allow optional joint reporting regarding say-on-pay votes in three scenarios:

- A single manager can "report say-on-pay votes in cases where multiple managers exercise voting power."[129]
- A fund can "report a manager's say-on-pay votes on behalf of a manager exercising voting power over some or all of the fund's securities."[130]

123. *See id.*

124. Proposed Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, Exchange Act Release No. 93169, 86 Fed. Reg. 57478 (Sept. 29, 2021), https://www.sec.gov/rules/proposed/2021/34-93169.pdf.

125. Enhanced Reporting of Proxy Votes, *supra* note 115, at 78774 (discussing additional scoping matters for manager reporting of say-on-pay votes).

126. *See id.* at 78775 (discussing a streamlined reporting option for such managers).

127. *See Form 13F*, U.S. Sec. & Exchange Commission, https://www.sec.gov/pdf/form13f.pdf (last visited Apr 15, 2023). Filers on Form 13F are permitted to exclude holdings with a fair market value below $200,000 and consisting of fewer than 10,000 shares.

128. *See generally id.*

129. Enhanced Reporting of Proxy Votes, *supra* note 115, at 78782 (discussing joint reporting provisions).

130. *Id.*

- "[T]wo or more managers who are affiliated persons [can] file a single report on Form N-PX for all affiliated person managers within the group, notwithstanding that they do not exercise voting power over the same securities."[131]

In these scenarios, the nonreporting manager will be required to file a notice or combination Form N-PX report to identify each manager or fund reporting on its behalf.[132] Additionally, when another reporting person reports say-on-pay votes on a manager's behalf, the report on Form N-PX that includes the manager's votes will be required to identify the manager (and any other managers) on whose behalf the filing is made, and separately identify the number of shares the manager is reporting on behalf of the nonreporting manager.[133] A reporting person (whether a manager or a fund) will also be required to report separately shares that are reported on behalf of different managers or groups of managers.[134]

Voted and Loaned Shares—Applies Only to Registered Funds. Under the current framework, funds are required to report only on matters on which the fund was entitled to vote.[135] The amendments expand the reporting obligations to securities on loan as of the record date for the shareholder meeting.[136] This is intended to ensure that a Form N-PX filing reflects the effect of the reporting person's securities lending activities on its proxy voting, since the reporting person is able to recall and vote these securities on loan.[137]

Additionally, the amendments will require reporting persons of Form N-PX also to disclose the number of shares that were voted and how they were voted as reflected in their records when a Form N-PX is filed, as well as the number of shares loaned and not recalled.[138] With respect to shares loaned and not recalled, the reporting obligations will apply only when the reporting person has loaned the securities, directly or indirectly, through a lending agent.[139] The obligations will not apply if the reporting person does not engage in shares lending

131. *Id.*

132. *See id.* at 78782–83 (discussing joint reporting provisions), 78811 (General Instructions C.5 and C.6 to amended Form N-PX), 78812–13 (Special Instructions C.2 and D.6 to amended Form N-PX).

133. *See id.* at 78783 (discussing technical changes to facilitate joint reporting).

134. *See id.* (discussing technical changes to facilitate joint reporting), 78813 (Special Instruction D.6 to amended Form N-PX).

135. *See Form N-PX*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/formn-px.pdf (last visited Apr. 15, 2022) (Item 1 of current Form N-PX).

136. Enhanced Reporting of Proxy Votes, *supra* note 115, at 78772 (discussing the scope of funds' Form N-PX reporting obligations).

137. *Id.*

138. *See id.* at 78778 (discussing the requirements of quantitative disclosures), 78818 (Item 1(i) of amended Form N-PX), 78813 (Special Instruction D.5 to amended Form N-PX).

139. *See id.* at 78781 (discussing the disclosure requirement of number of shares the reporting person loaned and did not recall), 78813 (Special Instruction D.7 to amended Form N-PX).

in a client's account.[140] To provide full context, reporting persons are also permitted to provide optional additional information about a particular vote.[141]

Identification of Proxy Voting Matters—Applies Only to Registered Funds. The final rule adopts the proposed voting matter identification requirements but, in a departure from the proposal, applies them only when an SEC proxy card is available for that matter.[142] That is, if a proxy is subject to Rule 14a-4 under the Exchange Act so that the proxy clearly identifies each voting matter, reporting persons are required to (1) identify proxy voting matters using the same language as is used in the issuer's form of proxy card, (2) report matters in the same order in which they are presented on the issuer's form of proxy card, and (3) identify each director separately for director election matters.[143] In all other cases, reports regarding proxy voting matters instead will be required to provide "a brief identification of the matter voted on," which is consistent with the current requirement.[144] The usage of abbreviations will be limited in such "brief identification" in order to help investors identify and compare voting matters.[145]

Categorization Framework. Form N-PX reporting persons will be required to identify the subject matter of each reported proxy voting item under a standardized categorization framework.[146] Compared to the proposed framework, the final framework has a more streamlined and consolidated list of categories, which is intended to respond to commentator concerns about complexity and uncertainty among potentially overlapping categories.[147] The final framework also eliminated the requirement to assign matters to subcategories, as had been proposed.[148] The list of categories in the framework will be nonexclusive and reporting persons will be required to select all applicable categories.[149]

The following table reflects the changes to categories from the proposed framework:[150]

140. *Id.* at 78781 (discussing the disclosure requirement of number of shares the reporting person loaned and did not recall).

141. *See id.* at 78780 (discussing the disclosure requirement of number of shares the reporting person loaned and did not recall), 78812 (Special Instruction B.4 to amended Form N-PX), 78818 (Item 1(o) to amended Form N-PX).

142. *See id.* at 78776 (discussing the identification of proxy voting matters on Form N-PX).

143. *See id.* at 78775 (discussing the identification of proxy voting matters on Form N-PX), 78813 (Special Instruction D.3 of amended Form N-PX).

144. *See id.* at 78776 (discussing the situation in which an SEC proxy card is not available), 78817 (Item 1(e) of current Form N-PX).

145. *See id.* at 78776 (discussing the usage of abbreviations in identification).

146. *See id.* at 78776–77 (discussing the identification of proxy voting categories).

147. *See id.* at 78777 (discussing the identification of proxy voting categories).

148. *Id.* (discussing the deviation from the proposed rule).

149. *See id.* at 78778 (discussing the identification of proxy voting categories), 78813 (Special Instruction D.4 of amended Form N-PX).

150. *Id.* at 78778 (Table 1—Changes to Categories From the Proposal).

Proposed Category	Adopted Category	Change from Proposal
Board of directors	Director elections	Limited to elections; other board matters categorized as corporate governance
Section 14A	Section 14A	None
Audit-related	Audit-related	None
Investment company matters	Investment company matters	None
Shareholder rights and defenses	Shareholder rights and defenses	None
Extraordinary transactions	Extraordinary transactions	None
Security issuance	n/a	Consolidated with capital structure
Capital structure	Capital structure	Now includes security issuance
Compensation	Compensation	None
Corporate governance	Corporate governance	Includes board matters other than director elections and meeting governance
Meeting governance	n/a	Consolidated with corporate governance
Environment or climate	Environment or climate	None
Human rights or human capital/workforce	Human rights or human capital/workforce	None
Diversity, equity, and inclusion	Diversity, equity, and inclusion	None
Political activities	n/a	Consolidated with other social issues
Other social issues	Other social issues	Now includes political activities
Other	Other	None

Other Aspects of Amended Form N-PX—Applies Only to Registered Funds. Registrants that offer multiple series (sometimes known as "series trusts" in which each series is its own fund having its own investment program and shareholders) will continue to be required to provide Form N-PX disclosure separately by series.[151] The Commission observes that this is a current requirement, but some registrants simply have noted which series voted on which matters rather than organizing the entire report on a series-by-series basis. Additionally, the information otherwise reported on Form N-PX will be required to be reported in the order presented on the issuer's form of proxy.[152]

151. *See id.* at 78781 (discussing the requirement to file Form N-PX separately by series), 78813 (Special Instruction D.9 to amended Form N-PX).

152. *See id.* at 78781 (discussing the requirement to present information in the same order), 78813 (Special Instruction D.1 to amended Form N-PX).

The amended Form N-PX will require reporting persons to indicate whether a vote was for or against management's recommendation.[153] In contrast to the proposed amendments, however, the final amendments will not require reporting persons to disclose whether a voting matter is a proposal or a counterproposal (as it may be challenging to distinguish between the two).[154]

To improve access to the information, reporting will be subject to structured data (electronic "tagging") requirements.[155] Fund reporting also will be required to be available on a firm's website instead of filed solely with the Commission as it is today.[156]

Finally, the amendments adopt some changes to the cover page and add a new summary page to Form N-PX.[157] Among other changes, the cover page will require reporting persons to check a box to categorize the report as one of the following types: "Fund Voting Report," "Fund Notice Report," "Institutional Manager Voting Report," "Institutional Manager Notice Report," or "Institutional Manager Combination Report."[158] Among other things, reporting persons will be required to disclose on the new summary page the names and the number of included managers with say-on-pay votes in list format.[159]

2. Confidentiality

Form N-PX (like Form 13F) is publicly filed via the EDGAR database on the Commission website. The Commission is providing an opportunity to prevent confidential information protected from disclosure on Form 13F from being disclosed on Form N-PX. These instructions to Form N-PX will provide that a person requesting confidential treatment of information filed on Form N-PX should follow the same procedures set forth in Form 13F for filing confidential treatment requests.[160] The Commission is also prescribing the required content of a confidential treatment request and the required filing of information that is no longer entitled to confidential treatment.[161] The Commission explicitly states that a confidential treatment will not be justified "solely in order to prevent proxy voting information from being made public."[162]

153. *Id.* at 78782 (discussing the requirement to disclose additional information in connection with the management's recommendation).
154. *Id.*
155. *See id.* at 78785 (discussing Form N-PX reporting data language).
156. *See id.* (discussing website availability of fund proxy voting records).
157. *See generally id.* at 78783 (discussing the cover page of Form N-PX), 78784 (discussing the summary page of Form N-PX).
158. *See generally id.* at 78783–84 (discussing the requirement to identify the type of the report).
159. *Id.* at 78785 (discussing the information required on the summary page).
160. *See id.* at 78787 (discussing confidential treatment requests).
161. *See generally id.* at 78787–88 (discussing confidential treatment requests).
162. *Id.* at 78788 (discussing the standards for confidential treatment request approval).

3. Effective Date

Reporting persons will continue to be required to report annually on Form N-PX no later than August 31 for the twelve-month period of July 1 to June 30.[163] The Commission delayed the effective date of the amendments until July 1, 2024, to allow time to prepare.[164] Therefore, funds and managers will be required to file their first amended Form N-PX by August 31, 2024, covering the period from July 1, 2023, to June 30, 2024.[165]

Additionally, as a transition measure, managers that are new filers of Form 13F will be required to file Form N-PX for the twelve-month period ending June 30 only for the calendar year following the manager's initial filing on Form 13F.[166] Managers also will not be required to file Form N-PX regarding any shareholder vote that occurs after September 30 of the calendar year in which the manager's final filing on Form 13F is due.[167] Instead, managers will file a short-period Form N-PX for the period from July 1 to September 30, which will be due no later than March 1 of the immediately following calendar year.[168]

D. Listing Standard for Recovery of Erroneously Awarded Compensation

On October 26, 2022, the Commission adopted new Rule 10D-1, directing national securities exchanges to establish listing standards that prohibit the listing of any security of a company that does not adopt and implement a written policy requiring the recovery, or "clawback," of certain incentive-based executive compensation.[169] Recovery under a clawback policy must be the amount of incentive compensation that is shown to have been paid in error, based on an accounting restatement that is necessary to correct a material error of a financial reporting requirement.[170]

In a significant expansion of the rule as originally proposed, Rule 10D-1 will require the recovery policy to apply to any accounting restatement to correct not only an error in previously issued financial statements that is material to the previously issued financial statements (also called a "Big R" restatement) but also an error that would result in a material misstatement if the error were corrected in

163. *See id.* (discussing the effective date).

164. *Id.*

165. *Id.*

166. *See* 17 C.F.R. § 240.14Ad-1(b) (2022); Enhanced Reporting of Proxy Votes, *supra* note 115, at 78789 (discussing the transition rules for managers), 78812 (General Instruction F to amended Form N-PX).

167. Enhanced Reporting of Proxy Votes, *supra* note 115, at 78789 (discussing the transition rules for managers).

168. *See* 17 C.F.R. § 240.14Ad-1(c) (2022); Enhanced Reporting of Proxy Votes, *supra* note 115, at 78789 (discussing the transition rules for managers), 78812 (General Instruction F to amended Form N-PX).

169. *See* Listing Standards for Recovery of Erroneously Awarded Compensation, 87 Fed. Reg. 73076 (Nov. 28, 2022) (to be codified at 17 C.F.R. pt. 229, 232, 240, 249, 270 & 274).

170. *Id.* at 73097.

the current period or left uncorrected in the current period (also called a "little r" restatement).[171]

If a current or former executive officer received erroneously awarded incentive-based compensation within the three fiscal years preceding the date of determination that a restatement is required, the company must recover the excess incentive-based compensation on a "no-fault" basis.[172] The rule also specifies disclosure requirements under newly created Item 402(w) relating to clawback policies and clawbacks.[173]

1. Mandated Listing Standards

Incentive-Based Compensation. Rule 10D-1 defines incentive-based compensation as any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure.[174] For this purpose, the term "financial reporting measures" means measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements and any measures derived wholly or in part from such financial information (such as non-GAAP financial measures). Additionally, Rule 10D-1 specifically adds stock price and total shareholder return as financial reporting measures for purposes of this rule.[175] The definition is drafted to cover any new forms of compensation and new performance measures that may arise in the future to determine or award incentive-based compensation.

Amounts Recoverable. The amount that listed companies would have to recover is the amount of incentive-based compensation received by the executive officer or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement.[176] Amounts recovered are computed without regard to taxes that may have been paid or incurred by the executive officer.[177]

To calculate the amount of the excess after an accounting restatement, the company would first need to recalculate both the applicable financial reporting measure and the amount of incentive-based compensation that was based on this measure. Next the company would have to determine whether the executive officer received a greater amount of incentive-based compensation based on the original calculation of the financial reporting measure than such officer would have received based on the recalculated financial reporting measure, after taking into account any discretion applied by the compensation committee to reduce the amount received. If the compensation was only partially based on the financial

171. *Id.*
172. *Id.* at 73100.
173. *Id.* at 73108.
174. *Id.* at 73092.
175. *Id.* at 73093.
176. *Id.* at 73097.
177. *Id.*

reporting measure performance goal, the company would need to determine the portion of the original compensation that was based on or derived from the restated financial measure. The company would then have to recalculate the affected portion to determine the excess amount to be recovered.

Because incentive-based compensation that is based on stock price or total shareholder return is not subject to mathematical recalculation directly from the information in an accounting restatement, Rule 10D-1 permits companies to determine the recoverable amount based on a reasonable estimate of the effect of the accounting restatement on stock price or total shareholder return, as applicable, in such circumstances.[178] When this occurs, the listed company must retain documentation of that estimate determination and provide it to the exchange.[179]

Recovery Mechanics. With respect to recoverable incentive-based compensation, the recovery mechanics will depend on the form in which the executive officer holds such compensation at the time of recovery.[180] The adopting release notes that the definition of erroneously awarded compensation is intended to be applied in a principles-based manner thereby allowing companies to adopt a more rigorous recovery policy, provided the minimum requirements set forth in the rules are satisfied.[181] The adopting release provided examples of how to calculate the recovery of certain types of incentive compensation:

For cash awards, the erroneously awarded compensation is the difference between the amount of the cash award (whether payable as a lump sum or over time) that was received and the amount that should have been received applying the restated financial reporting measure.

- For non-qualified deferred compensation, the executive officer's account balance or distributions would be reduced by the erroneously awarded compensation contributed to the nonqualified deferred compensation plan and the interest or other earnings accrued thereon under the nonqualified deferred compensation plan.
- For cash awards paid from bonus pools, the erroneously awarded compensation is the pro rata portion of any deficiency that results from the aggregate bonus pool that is reduced based on applying the restated financial reporting measure.
- For equity awards, if the shares, options, or SARs are still held at the time of recovery, the erroneously awarded compensation is the number of such securities received in excess of the number that should have been received applying the restated financial reporting measure (or the value of that excess number). If the options or SARs have been exercised, but the underlying shares have not been sold, the erroneously awarded

178. *Id.*
179. *Id.* at 73098.
180. *Id.* at 73097–98.
181. *Id.* at 73098.

> compensation is the number of shares underlying the excess options or SARs (or the value thereof).[182]

The Commission declined to provide additional guidance on recovery for other forms of incentive-based compensation, suggesting that those determinations will be made based on the individual facts and circumstances of the terms of the incentive compensation arrangements between the company and its executive officer.[183]

If the same compensation is recouped pursuant to section 304 of the Sarbanes-Oxley Act or other recovery provisions, such payment would reduce the amounts recoverable under the listing standards.[184]

Employees Covered. Rule 10D-1 as adopted applies to any individual who, after beginning service as an executive officer, served as an executive officer of the listed company at any time during the performance period for that incentive-based compensation, whether or not such individual is an executive officer at the time the company is seeking recovery.[185] The clawback is not limited to NEOs (i.e., those executive officers whose compensation is described in the company's proxy statement).[186] Furthermore, the clawback is not limited to executive officers who engaged in misconduct or were directly involved with the accounting error.[187]

Restatements. Rule 10D-1 requires a clawback of incentive-based compensation when a listed company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the securities laws, including any required accounting restatement to correct an error (1) in previously issued financial statements that is material to the previously issued financial statements or (2) that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.[188]

The rules as adopted consider both "Big R" and "little r" restatements to be within the scope of the recovery policy contemplated by Congress because "both result in revisions of previously issued financial statements for a correction of an error in those financial statements."[189]

The rules as adopted do not define "accounting restatement" or "material noncompliance." Existing accounting standards and guidance already provide meanings for both terms. The following types of financial statement changes are not considered corrections of errors and, therefore, would not trigger a clawback under Rule 10D-1:

182. *Id.*
183. *Id.*
184. *Id.* at 73098–99.
185. *Id.* at 73089.
186. *Id.* at 73090.
187. *Id.*
188. *Id.* at 73085.
189. *Id.*

- Retrospective application of a change in accounting principle;
- Retrospective revision to reportable segment information due to a change in the structure of an company's internal organization;
- Retrospective reclassification due to a discontinued operation;
- Retrospective application of a change in reporting entity, such as from a reorganization of entities under common control;
- Retrospective adjustment to provisional amounts in connection with a prior business combination (IFRS filers only); and
- Retrospective revision for stock splits, reverse stock splits, stock dividends, or other changes to capital structure.[190]

Look-Back Period. Rule 10D-1 requires listed companies to recover incentive-based compensation received during the three completed fiscal years immediately preceding the date that the company is required to prepare an accounting restatement, which is considered to occur for purposes of Rule 10D-1 on the earlier to occur of:

- The date the listed company's board of directors, board committee, or authorized officer or officers concludes, or reasonably should have concluded, that the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the securities laws.
- The date a court, regulator, or other legally authorized body directs the company to prepare an accounting restatement.[191]

The adopting release provides the following example on the timing of the look-back period: if a company that reports on a calendar year basis concludes in November 2024 that a restatement of previously issued financial statements is required and files the restated financial statements in January 2025, the three-year look-back period would apply to compensation received in 2021, 2022, and 2023.[192]

In arriving at a conclusion that an accounting restatement is required, the adopting release points out that while not dispositive, companies should carefully consider any notice from the company's independent auditors that previously issued financial statements contain a material error.[193] The triggering event is the determination that an accounting restatement needs to be prepared, which may precede the determination of the actual amount of the error.[194]

190. *Id.* at 73086–87.
191. *Id.* at 73088.
192. Listing Standards for Recovery of Erroneously Awarded Compensation, Exchange Act Release No. 96159, 87 Fed. Reg. 73076, 73096 (Oct. 26, 2022), https://www.sec.gov/rules/final/2022/33-11126.pdf.
193. *Id.* at 73088.
194. *Id.* at 73085.

Incentive-based compensation would be deemed received in the fiscal period in which the financial reporting measure is attained, even if the payment or grant occurs in a subsequent fiscal period.[195] When the officer's right to the incentive-based compensation is subject to multiple conditions, the award is deemed received for purposes of the clawback when the relevant financial reporting measure performance goal is attained, regardless of whether the executive officer has only a contingent right to payment.[196]

The date of the receipt of the compensation varies depending on the terms of the award and the type of the award. The adopting release provides the following examples:

- If the grant of the award is based, either wholly or in part, on satisfaction of a financial reporting measure performance goal, the award would be deemed received in the fiscal period when that measure is satisfied;
- If an equity award vets only upon satisfaction of a financial reporting measure performance condition, the award would be deemed received in the fiscal period when it vests;
- A non-equity incentive plan award would be deemed received in the fiscal year that the executive officer earns the award based on the satisfaction of the relevant financial reporting measure performance goal rather than on a subsequent date on which the award was paid; and
- A cash award earned upon satisfaction of a financial reporting measure performance goal would be deemed received in the fiscal period when the measure is satisfied.[197]

Ministerial acts, such as calculating the amount earned or certification of the attainment of the financial measure by the board or a board committee, do not affect the determination of the date received.[198] Incentive-based compensation would be subject to recovery under Rule 10D-1 only if the executive officer receives such compensation while the company has a class of securities listed on an exchange.[199]

Covered Companies. With very few exceptions, the clawback listing standards apply to all listed companies.[200] This means that FPIs, SRCs, emerging growth companies, business development companies, and companies that list only debt or preferred securities would be subject to the clawback listing standards to the extent that they have securities listed on a national securities

195. Listing Standards for Recovery of Erroneously Awarded Compensation, *supra* note 169, at 73095.
196. *Id.*
197. *Id.*
198. *Id.* at 73095–96.
199. *Id.* at 73095.
200. *Id.* at 73079.

exchange. Rule 10D-1 does not grant securities exchanges the discretion to exempt any categories of companies from the listing standards.[201]

Mandatory Clawback. Rule 10D-1 mandates recovery of erroneously awarded compensation in compliance with a company's recovery policy except to the extent that pursuit of recovery would be impracticable.[202] Despite the urging of commenters, the Commission did not provide a board of directors with very much latitude to exercise discretion.[203] Rule 10D-1 allows for only three narrow exceptions where recovery is considered impractical: (1) the direct cost of recovery would exceed the amount of recovery, (2) the recovery would violate home country law and additional conditions are met, and (3) potential disqualification of tax-qualified retirement plans.[204]

For each of these exceptions, the determination would have to be made by a committee of independent directors that is responsible for executive compensation decisions, such as a compensation committee or, in the absence of such a committee, by a majority of the independent directors.[205] In addition, as discussed below, the company would need to disclose why it did not pursue the recovery.[206] The determination is subject to review by the applicable exchange.[207]

Rule 10D-1 does allow companies to exercise discretion in how to accomplish recovery, recognizing that the means of recovery may vary by the type of compensation arrangement, as well as by company, provided that the recovery of excess incentive-based compensation must be pursued "reasonably promptly."[208] However, the rule does not provide a definition for "reasonably promptly," noting that reasonableness may vary by the costs incident to recovery efforts.[209]

Indemnification Prohibited. Listed companies are prohibited from indemnifying their executive officers for incentive compensation recoverable pursuant to clawback policies and from paying the premiums on any insurance policy protecting against such recoveries.[210]

Non-Compliance. Under the rules as adopted, a company would be subject to delisting if it does not adopt a compensation recovery policy that complies with applicable listing standards, adopt a compensation recovery policy that complies with applicable listing standards, or provide the required disclosures in accordance with Commission rules.[211]

201. *Id.*
202. *Id.* at 73100.
203. *Id.*
204. *Id.* at 73101.
205. *Id.* at 73103.
206. *Id.* at 73101.
207. *Id.*
208. *Id.* at 73104.
209. *Id.*
210. *Id.* at 73110.
211. *Id.* at 73080.

2. Disclosure Requirements

The rules require listed companies to: (1) file their clawback policies as exhibits to their annual reports on Form 10-K, Form 20-F, or Form 40-F, as applicable; (2) make disclosures relating to their compliance with their compensation recovery policy; (3) provide the additional information in Inline XBRL; and (4) include additional check box disclosure on the cover of their Form 10-K, 20-F, or 40-F.[212]

Additional Item 402 Disclosure. The Commission has adopted new subsection (w) to Item 402 of Regulation S-K, which requires disclosure in proxy and information statements if during or after its last completed fiscal year a listed company either (1) was required to prepare an accounting restatement that required a clawback under the company's clawback policy or (2) had an outstanding balance of unrecovered excess incentive-based compensation relating to a prior restatement.[213] In these circumstances, a listed company would be required to disclose:

- For each restatement:
  - The date on which the company was required to prepare an accounting restatement;
  - The aggregate dollar amount of erroneously awarded compensation resulting from the restatement (including an analysis of how the amount was calculated);
  - If the financial reporting measure that was restated related to stock price or total shareholder return, the estimates used to determine the erroneously awarded compensation attributable to the restatement, and an explanation of the methodology used for such estimates;
  - The aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the last completed fiscal year; and
  - If the aggregate dollar amount of erroneously awarded compensation has not yet been determined, disclosure of that fact and an explanation therefor, with the information required for each restatement required to be disclosed in the next filing that includes disclosure pursuant to Item 402 of Regulation S-K.
- If recovery would be impracticable, for each current and former named executive officer and for all other current and former executive officers as a group, the amount of recovery forgone and a brief description of the reason the company decided in each case not to pursue recovery; and

212. *Id.* at 73130.
213. *Id.* at 73107.

- For each current and former named executive officer from whom, as of the end of the last completed fiscal year, erroneously awarded compensation had been outstanding for 180 days or longer since the date the company determined the amount the individual owed, the dollar amount of outstanding erroneously awarded compensation due from each such individual.[214]

Any disclosure regarding impracticability of recovery must include the specific exception on which the company is relying, and should provide additional context relating to that exception, such as a brief explanation of the direct expenses paid to a third party to assist in enforcing the recovery policy, identification of the provision of foreign law that recovery would violate, or a description of how recovery would cause a tax-qualified retirement plan to fail to meet the applicable statutory requirements.[215]

The new Item 402(w) disclosure requirement is separate from the compensation discussion and analysis (CD&A) requirement, but a listed company could choose to include it in its CD&A discussion if it is required to prepare a CD&A discussion.[216]

Additionally, if at any time during or after its last completed fiscal year a company was required to prepare an accounting restatement, and concluded that recovery of erroneously awarded compensation was not required pursuant to the company's compensation recovery policy required by the listing standards adopted pursuant to Rule 10D-1, the company must briefly explain why application of its recovery policy resulted in this conclusion.[217]

Information disclosed pursuant to Item 402(w) will not be deemed to be incorporated by reference into any filing under the Securities Act unless specifically so incorporated.[218] Finally, the compensation recovery disclosures must have specific data points tagged, as well as block text tagging of the disclosures, in Inline XBRL.[219]

Summary Compensation Table Revisions. When prior year compensation disclosed in a summary compensation table has been recovered, the amount shown in the applicable column and the total column of the summary compensation table must be reduced to include only the amount retained by the executive officer, with a footnote explaining the recovery.[220] For example, if the company reported that in 2024 its chief executive officer earned $1 million in non-equity incentive plan compensation, and in 2025 a restatement of 2024 financial statements resulted in recovery of $300,000 of that compensation, the company's 2025 summary compensation table would revise the 2024 reported amount for non-equity incentive plan compensation to $700,000,

214. *Id.* at 73107.
215. *Id.*
216. *Id.* at 73108.
217. *Id.* at 73108–09.
218. *Id.* at 73108.
219. *Id.* at 73109.
220. *Id.*

provide footnote disclosure explaining that the company recovered $300,000 of previously reported compensation, and make a comparable change to 2024 total compensation for such officer.

Additional Check Boxes. To promote greater transparency around accounting restatements generally, the cover page to Form 10-K, Form 20-F, and Form 40-F will include new check boxes where companies must indicate separately: (1) whether the financial statements included in the filing reflect correction of an error to previously issued financial statements and (2) whether any of those error corrections are restatements that required a recovery analysis of incentive-based compensation received by any of the company's executive officers during the relevant recovery period pursuant to Rule 10D-1.[221]

3. Transition Period

Securities exchanges must file their proposed listing standards within ninety days after the publication of Rule 10D-1 in the Federal Register.[222] The new listing standards must be effective no later than one year following the date Rule 10D-1 is published in the Federal Register.[223]

Once clawback listing standards become effective, each company with securities listed on the applicable exchange must adopt a compliant clawback policy within sixty days.[224] The clawback requirement applies to erroneously awarded compensation received on or after the effective date of the applicable listing standard.[225]

Listed companies would have to include the new clawback disclosures in proxy or information statements and Exchange Act annual reports filed on or after the effective date of the listing standards.[226]

E. Proxy Voting Advice

On July 13, 2022, the Commission adopted final amendments regarding the applicability of the proxy rules to proxy advisory firms, which are also known as proxy voting advice businesses ("PVABs").[227] The amendments relating to PVABs, such as ISS and Glass Lewis, remove certain conditions to the availability of exemptions from the information and filing requirements of the proxy rules for PVABs; these conditions were added as part of rules adopted by the previous presidential administration in 2020.[228] The key reversal from 2020 is the rescission of the conditions that:

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221. *Id.* at 73107.
222. *Id.* at 73111.
223. *Id.*
224. *Id.*
225. *Id.*
226. *Id.*
227. *See Proxy Voting Advice*, Exchange Act Release No. 34-95266, U.S. Sec. & Exchange Commission (July 19, 2022), https://www.sec.gov/rules/final/2022/34-95266.pdf.
228. *See id.*

1. Companies that are the subject of proxy voting advice have such advice made available to them before or at the same time PVABs make it available to their clients.

2. Clients of PVABs are notified of any written responses by companies to such proxy voting advice.[229]

The amendments also reversed course by rescinding a related note to Rule 14a-9 of the Exchange Act and supplemental guidance regarding the proxy voting obligations of investment advisers from the 2020 rules as described below.[230] The amendments leave intact, however, the determination that proxy voting advice is a solicitation subject to the proxy rules—including liability under Rule 14a-9 for material misstatements or omissions of fact—and the conflicts of interest disclosure requirements that were memorialized in the 2020 rules.[231]

The amendments became effective on September 19, 2022, and are referred to below as the "2022 amendments."

1. Background

In 2020, the Commission adopted final rules regarding proxy voting advice provided by PVABs.[232] The 2020 rules, among other things:

1. Codified the SEC's interpretation that proxy voting advice is generally a "solicitation" subject to the proxy rules.

2. Added new conditions to exemptions that PVABs generally rely on in order to avoid the proxy rules' information and filing requirements, including:

   a. New conflicts of interest disclosure requirements.

   b. A requirement that PVABs adopt and disclose policies and procedures designed to ensure that companies that are the subject of proxy voting advice have such advice made available to them in a timely manner, as well as a requirement that clients of PVABs are provided with a means of becoming aware of any written responses by companies to proxy voting advice.

3. Added Note (e) to Rule 14a-9, the anti-fraud provision for proxy materials, to include examples of material misstatements or omissions related to proxy voting advice.[233]

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229. *See id.*
230. *See id.*
231. *See id.*
232. *See Exemptions from the Proxy Rules for Proxy Voting Advice*, Exchange Act Release No. 34-89372, U.S. Sec. & Exchange Commission (July 22, 2020), https://www.sec.gov/rules/final/2020/34-89372.pdf.
233. *See id.*

The 2022 amendments reversed the additions of Items 2(b) and 3 in the 2020 rules, which never actually went into effect, as discussed in greater detail below.[234]

2. Final Amendments

The 2020 rules added paragraph (9) to Rule 14a-2(b), which specifies certain conditions that a PVAB must satisfy in order to rely on the exemptions from the proxy rules' information and filing requirements.[235] The 2022 amendments removed the conditions that:

1. Companies that are the subject of proxy voting advice have such advice made available to them in a timely manner.
2. Clients of PVABs are provided with a means of becoming aware of any written responses by companies to proxy voting advice.[236]

These conditions were adopted in 2020 in response to concerns by companies that the analyses by PVABs contained errors and methodological weaknesses that could affect the reliability of their voting recommendations, and that companies did not have adequate opportunities to engage with the PVABs regarding their advice to correct errors on a timely basis.[237] The rescission of these conditions will reignite these concerns for companies, with companies not having a prescribed avenue to respond to proxy voting advice that contains errors or with which they disagree. In addition to the rescission of the conditions themselves, the 2022 amendments removed accompanying safe harbors and exclusions that relate to these conditions.[238] However, the other condition added in the 2020 rules for reliance on the exemptions—that PVABs provide their clients with certain conflicts of interest disclosures in connection with their proxy voting advice—remains in place.[239]

The 2020 rules also codified that PVABs' proxy voting advice generally constitute a solicitation subject to the proxy rules, including Rule 14a-9, which "prohibits any solicitation from containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact."[240] Rule 14a-9 also requires that solicitations "must not omit to state any material fact necessary in order to make the statements therein not false or misleading."[241]

234. *See supra* note 222.
235. *See supra* note 227.
236. *See* Proxy Voting Advice, Exchange Act Release No. 34-95266, 87 Fed. Reg. 43168, 43170–78 (July 13, 2022), https://www.sec.gov/rules/final/2022/34-95266.pdf.
237. *See* Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 34-89372, 85 Fed. Reg. 55082, 55085 (Jul. 22, 2020) https://www.sec.gov/rules/final/2020/34-89372.pdf.
238. *See supra* note 236.
239. *See id.*
240. 17 C.F.R. § 240.14a-9 (2022).
241. *Id.*

As part of the 2020 rules, Rule 14a-9 was amended to add Note (e) to provide examples of proxy voting advice that may, depending on the facts and circumstances, be misleading within the meaning of the rule, specifically citing as a potential example the failure of a PVAB to disclose its "methodology, sources of information, or conflicts of interest."[242] The 2022 amendments deleted Note (e) from Rule 14a-9, removing the specific examples of proxy voting advice that may be subject to the rule.[243] However, the Commission was intentional in stating that this deletion does not alter the scope of Rule 14a-9 or its application to proxy voting advice—the deletion instead was purportedly aimed at removing the "risk of confusion" created by Note (e).[244] The Commission also reiterated its position included in the proposing release that Rule 14a-9 liability does not extend to mere differences of opinion between PVABs and companies, subject to certain limited circumstances in which a statement of opinion contains a material misstatement or omission of fact.[245]

Finally, the 2022 amendments rescinded supplemental guidance the Commission issued to investment advisers in 2020 about their proxy voting obligations.[246] The 2020 supplemental guidance addressed investment advisers' use of automated proxy voting systems hosted by PVABs, which have amounted to "robo-voting" in the views of many companies.[247] The 2020 supplemental guidance was primarily intended to assist investment advisers in considering company responses to proxy voting advice that would have been more readily available as a result of the 2020 rules—given the rescission of the conditions discussed above, the Commission determined this guidance also should be removed.[248]

Under the final proxy advisor rules, proxy advisory firms will be left with broad discretion in determining when and how to engage with companies relating to their voting advice. With the rescission of the conditions in the 2020 rules aimed at fostering engagement, there is no regulatory impetus for proxy advisory firms, including ISS and Glass Lewis, to engage with companies or to ensure that company responses to voting advice are received by shareholder clients. While market forces have led to engagement with companies through voluntary procedures, the timing and nature of this engagement will continue to rest with these proxy advisory firms—and there is no guarantee the current practices will be maintained.

242. *See* Exemptions from the Proxy Rules, *supra* note 237, at 55118–12.
243. *See supra* note 236.
244. *See* Exemptions from the Proxy Rules, *supra* note 237, at 55096–99.
245. *See* Proxy Voting Advice, *supra* note 236, at 43181.
246. *See id.* at 43178.
247. *See* Exemptions from the Proxy Rules, *supra* note 237, at 55086.
248. *See* Proxy Voting Advice, *supra* note 236, at 43178.

F. Inflation Adjustments Under Titles I and III of the JOBS Act

On September 9, 2022, the Commission adopted amendments to the Jumpstart Our Business Startups Act ("JOBS Act").[249] Under the JOBS Act, the Commission is statutorily required to adjust rules according to inflation once every five years.[250] These amendments applied to both the emerging growth company and Regulation Crowdfunding sections.[251]

Emerging Growth Companies. The JOBS Act defines "emerging growth company" to mean an issuer that has a total annual gross revenue of less than $1 billion (subsequently adjusted in 2017 as noted below), indexed for inflation every five years.[252] The Commission's intention is to scale disclosure requirements for newly public companies, generally lasting for five years after the IPO. Due to rising inflation, and the JOBS Act recurring indexing requirement, the threshold for qualifying as an emerging growth company significantly increased. Last adjusted in 2017, the Commission increased the threshold for a business to be qualified as an emerging growth company from $1.07 billion to $1.235 billion.[253]

Regulation Crowdfunding. The JOBS Act amended the exemption from registration requirements of section 5 of the Securities Act for certain crowdfunding transactions.[254] The exemption is limited by a maximum amount that the issuer may sell in a twelve-month period under the crowdfunding exemption. This statute also calls for an adjustment every five years correlating to the newly indexed inflation rate. However, the Commission did not adjust the overall offering limit for Regulation Crowdfunding since the offering limit was increased effective March 2021 from $1.07 million to $5 million, and this increase was greater than the inflation-based increase that would otherwise have occurred as a result of the periodic review.

Last adjusted in 2017, the Commission made multiple dollar threshold adjustments to Rule 100 of Regulation Crowdfunding (Offering Maximum and Investment Limits):

- The threshold for assessing investor's annual income or net worth to determine investment limits (Rules 100(a)(2)(i) and 100(a)(2)(ii)) was increased from $107,000 to $124,000.
- The lower threshold of Regulation Crowdfunding securities permitted to be sold to an investor if annual income or net worth is less than $124,000 (Rule 100(a)(2)(i)) was increased from $2,200 to $2,500.

249. *See* Inflation Adjustments Under Titles I and III of the JOBS Act, 87 Fed. Reg. 57394 (Sept. 20, 2022) (to be codified at 17 C.F.R. pts. 227, 230, 239 & 240).
250. *Id.* at 57394.
251. *Id.* at 57394–95.
252. *Id.* at 57395.
253. *Id.*
254. *Id.*

- The maximum amount that can be sold to an investor under Regulation Crowdfunding in a twelve-month period (Rule 100(a)(2)(ii)) was increased from $107,000 to $124,000.[255]

The Commission also adjusted the threshold amounts in Rule 201(t) of Regulation Crowdfunding:

- The threshold offering amount to qualify under 201(t)(1), where financial statements can be certified by the principal executive officer of the issuer, was raised from $107,000 to $124,000.
- The threshold offering amount to qualify under 201(t)(2), where financial statements of the issuer can be reviewed by a public accountant that is independent of the issuer, was raised from $535,000 to $618,000.
- The threshold offering amount to qualify under 201(t)(3), where financial statements of the issuer must be audited by a public accountant that is independent of the issuer, was raised from $1,070,000 to $1,235,000.[256]

This final rule was considered to be exempt from the notice and comment period of the Administrative Procedures Act since it does not impose any new substantive regulatory requirements on any person.[257]

255. *Id.* at 57395–96.
256. *Id.* at 57396.
257. *Id.*

Accounting Developments 2022

A. The Holding Foreign Companies Accountable Act

The year 2022 saw significant developments in the years-long effort to secure access for the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") to carry out its regulatory responsibilities with respect to registered public accounting firms based in China and Hong Kong that audit the financial statements of Chinese companies whose securities are traded or offered in the U.S. public markets. The catalyst was actions taken by the PCAOB and the SEC pursuant to the Holding Foreign Companies Accountable Act (the "HFCA Act").[1] This law, which was enacted in late 2020, threatened to impose U.S. trading prohibitions on the securities of Chinese issuers whose auditors could not be fully inspected or investigated by the PCAOB for three consecutive years as a result of restrictions imposed by Chinese authorities. During 2022, however, the PCAOB entered into an agreement with Chinese regulators to secure access to the Chinese accounting firms, and, in December 2002, the PCAOB announced that its inspectors had obtained the full access contemplated by the agreement. As a result, the looming trading prohibition threat has been lifted, at least for now.

1. Background

The Sarbanes-Oxley Act of 2002 created the PCAOB to regulate audits of financial statements of companies whose securities are traded in the United States or who are publicly offering securities in the United States.[2] The PCAOB's regulatory authority has four major components: (a) mandatory registration of public accounting firms that audit, or substantially participate in auditing, U.S. public companies; (b) establishment of auditing and other professional standards applicable to U.S. public company audits; (c) periodic inspections of registered public accounting firms to assess the firms' and their associated persons' compliance with the Sarbanes-Oxley Act, PCAOB and SEC rules, and professional standards; and (d) investigations and disciplinary proceedings arising from potential violations of applicable laws, rules, and professional standards.[3] Importantly, the Sarbanes-Oxley Act provides that a foreign public accounting firm that audits an issuer of securities traded or publicly offered in the United States is subject

1. Pub. L. No. 116-222, 134 Stat. 1063 (2020).
2. Sarbanes-Oxley Act of 2002 §§ 101–110, 15 U.S.C. §§ 7211–7220 (2018).
3. *Id.* §§ 102–105, 15 U.S.C. §§ 7212–7215.

to the Act in the same manner and to the same extent as a U.S.-based accounting firm.[4]

Application of PCAOB regulation to non-U.S. accounting firms raised issues of extraterritorial enforcement of U.S. laws almost from the outset. With the cooperation of foreign regulators, the PCAOB has succeeded over the years in conducting inspections of firms in many non-U.S. jurisdictions.[5] However, some countries, most notably the People's Republic of China ("PRC"), refused to permit the PCAOB access to their countries to conduct inspections or investigations of accounting firms headquartered in those countries or of their associated persons. This was problematic due to the large number of Chinese companies whose securities were traded in the United States, but whose financial statements were audited by accounting firms that were headquartered in mainland China or Hong Kong.

The HFCA Act was enacted in 2020 to address, among other things, the failure of the PRC to permit PCAOB access to carry out its regulatory responsibilities with respect to China-based accounting firms. Among other provisions, the HFCA Act requires the SEC to identify issuers whose financial statements were audited by a firm that had a branch or office located in a foreign jurisdiction and that "the Board is unable to inspect or investigate completely because of a position taken by an authority in the foreign jurisdiction . . . , as determined by the Board."[6] The HFCA Act also required the SEC to prohibit trading in the securities of any issuer that the SEC has identified as not being subject to inspection or investigation for three consecutive "non-inspection years."[7]

Pursuant to the HFCA Act and PCAOB Rule 6100, which the PCAOB adopted to implement its obligations under the HFCA Act,[8] on December 16, 2021, the PCAOB issued a report ("2021 Determination Report") setting forth its determinations that it was unable to inspect or investigate completely PCAOB-registered public accounting firms headquartered in mainland China or Hong Kong because of a position taken by one or more authorities in those jurisdictions.[9]

4. *Id.* § 106(a)(1), 15 U.S.C. § 7216(a)(1).

5. *See International*, Pub. Co. Acct. Oversight Bd., https://pcaobus.org/oversight/international (last visited Jan. 19, 2023).

6. Sarbanes-Oxley Act of 2002 § 104(i)(2)(A), 15 U.S.C. § 7214(i)(2)(A) (Supp. II 2020) (added by Holding Foreign Companies Accountable Act, Pub. L. No. 116-222, § 2, 134 Stat. 1063, 1063 (2020)). The HFCA Act also requires companies identified by the Commission pursuant to § 104 (i)(2)(A) to make certain disclosures in their SEC reports. *See* Subcomm. on Annual Rev., Comm. on Fed. Regulation of Sec., ABA Bus. Law Section, *Annual Review of Federal Securities Regulation*, 77 Bus. Law. 873, 875–78 (2022).

7. Sarbanes-Oxley Act of 2002 § 104(i)(3)(A), 15 U.S.C. § 7214(i)(3)(A) (Supp. II 2020) (added by Holding Foreign Companies Accountable Act, Pub. L. No. 116-222, § 2, 134 Stat. 1063, 1063 (2020)). The HCFA Act was amended in 2022 to reduce the period of consecutive non-inspection years from three to two. *See infra* notes 21–23 and accompanying text.

8. *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.

9. 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 [hereinafter 2021 Determination Report].

The 2021 Determination Report identified the registered firms that were subject to the PCAOB determinations. The Report started the clock ticking on the three-year non-inspection period that would trigger the trading prohibition.

2. 2022 Developments

Based on the PCAOB's 2021 Determination Report, beginning in March 2022, the SEC identified Chinese issuers whose annual reports for 2021 indicated that their financial statements had been audited by a registered public accounting firm that had been identified by the PCAOB in its 2021 Determination Report. Ultimately, the SEC conclusively identified over 170 such issuers.[10] Under the HFCA Act, each company's fiscal year that ended prior to the date of identification was deemed a "non-inspection year," and 2021 was the first of the three consecutive years that would trigger the trading prohibition. The identification of specific companies that were subject to the trading ban, and the market impact on these companies, increased the pressure to reach a resolution of the United States–China regulatory dispute.

On August 26, 2022, the PCAOB announced that it had signed a Statement of Protocol ("Protocol") with the China Securities Regulatory Authority and the Ministry of Finance of the People's Republic of China ("PRC Authorities") to permit the PCAOB to inspect and investigate registered public accounting firms based in China or Hong Kong that audit U.S. issuers.[11] According to the PCAOB, the Protocol, the text of which was not made public, included "comprehensive, explicit, and detailed" provisions to enable the PCAOB to carry out its regulatory functions with respect to China-based firms:

a) Sole PCAOB discretion to select the firms, audit engagements, and potential violations it inspects and investigates—without consultation with, nor input from, PRC Authorities;

b) Specific procedures for PCAOB inspectors and investigators to view complete audit work papers with all information included and for the PCAOB to retain information as needed; and

c) Direct PCAOB access to interview and take testimony from all personnel associated with the audits the PCAOB inspects or investigates.[12]

10. *See Holding Foreign Companies Accountable Act*, U.S. Sec. & Exchange Commission, https://www.sec.gov/hfcaa (last visited Jan. 17, 2023).

11. Press Release, Pub. Co. Acct. Oversight Bd., PCAOB Signs Agreement with Chinese Authorities, Taking First Step Toward Complete Access for PCAOB to Select, Inspect and Investigate in China (Aug. 26, 2022), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-signs-agreement-with-chinese-authorities-taking-first-step-toward-complete-access-for-pcaob-to-select-inspect-and-investigate-in-china.

12. *See* HFCAA Determination Report, PCAOB Release No. 104-HFCAA-2022-001, at 6 (Dec. 15, 2022), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/international/documents/2022-hfcaa-determination-report.pdf?sfvrsn=1345a530_2 [hereinafter PCAOB 2022 Determination Report]; *see also id.* at 9–11 (more detailed description of terms).

The Protocol represented a substantial achievement in addressing the PCAOB's longstanding inability to inspect or investigate China-based firms. The PCAOB emphasized, however, that the Protocol was a "first step" and that "the real test will be whether the words agreed to on paper translate into complete access in practice."[13] The PCAOB indicated that the PCAOB inspection team would be on the ground in China by mid-September 2022.[14]

On December 15, 2022, the PCAOB announced that it had "secured complete access to inspect and investigate registered public accounting firms headquartered in mainland China and Hong Kong."[15] Accordingly, the PCAOB voted to vacate its determinations in the 2021 Determination Report.

The Board issued a formal report ("2022 Determination Report") describing in detail the terms of the Protocol, the PCAOB's inspection and investigation activities with respect to mainland China and Hong Kong–headquartered audit firms, and the PRC Authorities' actions to facilitate PCAOB access in accordance with the Protocol. The 2022 Determination Report noted that by executing the Protocol, the PRC Authorities reversed positions they had previously taken that impaired the PCAOB's ability to conduct inspections and investigations, subject to the PRC Authorities in fact providing the PCAOB with complete access to inspect and investigate.[16] Based on its inspection and investigation activities, the Board found that "the [Protocol's] prescriptive framework has worked as intended."[17] The PCAOB "was able to complete field work on two audit firm inspections, obtain all requested documents and other information in both inspections and multiple investigations, and take testimony of all witnesses sought by the PCAOB in two investigations."[18] Accordingly, the Board "concluded that, consistent with the [HFCA Act], the Board is able to inspect and investigate completely firms headquartered in mainland China and Hong Kong" and vacated the 2021 determinations pursuant to PCAOB Rule 6100(h).[19] The Board emphasized that it would reconsider its determination if, in the future, it encountered impediments to inspections or investigations in China or Hong Kong as a result of positions taken by an authority in either jurisdiction.[20]

The Protocol and its apparently successful implementation represent a substantial achievement for the PCAOB. It also demonstrated the efficacy of Congress' strong-arm approach in the HFCA Act. Hopefully, removing the trading prohibition threat (assuming continuing Chinese cooperation) will encourage Chinese companies to continue to avail themselves of the U.S. capital markets,

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13. Press Release, *supra* note 11.
14. *Id.*
15. Press Release, Pub. Co. Acct. Oversight Bd., PCAOB Secures Complete Access to Inspect, Investigate Chinese Firms for First Time in History (Dec. 15, 2022), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-secures-complete-access-to-inspect-investigate-chinese-firms-for-first-time-in-history.
16. PCAOB 2022 Determination Report, *supra* note 12, at 7.
17. *Id.* at 8.
18. *Id.*
19. *Id.* at 9.
20. *Id.* at 20.

while providing to U.S. investors previously unavailable protections under the Sarbanes-Oxley Act regarding the audits of these companies' financial statements.

3. Amendment of the HFCA Act

On December 29, 2022, President Joseph R. Biden, Jr., signed the Consolidated Appropriations Act, 2023.[21] Although primarily an "omnibus" appropriations bill, this act also includes a provision amending the HFCA Act.[22] The amendment changes section 104(i)(3)(A) of the Sarbanes-Oxley Act[23] to reduce from three to two the number of consecutive non-inspection years that will trigger a trading prohibition of a covered issuer. This amendment has no immediate effect, in light of the PCAOB's determinations that, in 2022, it was able to conduct inspections and investigations completely of registered public accounting firms headquartered in mainland China and Hong Kong, and that the PRC Authorities had not taken a position to restrict PCAOB access or otherwise impair its ability to conduct its planned inspections and investigations. However, the shortened timeframe for triggering a trading prohibition should maintain pressure on the PRC Authorities to continue to permit full PCAOB inspections and investigations in 2023 and subsequent years.

B. Accounting Standards Updates

In 2022, the Financial Accounting Standards Board (the "FASB" or the "Board") issued six Accounting Standards Updates ("ASUs") to its Accounting Standards Codification ("ASC" or the "Codification"), compared to ten ASUs in 2021. The ASUs make improvements to fair value hedging methodologies, eliminate certain accounting guidance for troubled debt restructurings and enhance related disclosures, resolve a divergence in practice regarding fair value measurements of equity securities that are subject to contractual sale restrictions, mandate new disclosures related to supplier finance programs, allow certain exceptions for insurance providers when applying retrospective disclosure requirements for long-duration contracts, and further defer the sunset date for reference rate reform. The following discussion summarizes the ASUs issued by the FASB in 2022.

1. Update 2022-01—Derivatives and Hedging (Topic 815): Fair Value Hedging—Portfolio Layer Method

On March 28, 2022, the FASB issued ASU 2022-01 to allow multiple hedged layers to be designated for a single closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments.[24] This

21. Pub. L. No. 117-328, 136 Stat. 4459 (2022).
22. *Id.* div. AA, tit. III, § 301, 136 Stat. at 5536.
23. 15 U.S.C. § 7214(i)(3) (2018).
24. Fin. Acct. Standards Bd., Accounting Standards Update No. 2022-01, Derivatives and Hedging (Topic 815) (Mar. 2022) [hereinafter ASU 2022-01].

amendment enables entities to achieve hedge accounting for a greater proportion of the interest rate risk that is inherent in the assets included in the closed portfolio.[25]

FASB last made targeted improvements to the optional hedge accounting model under Topic 815 in August 2017.[26] ASU 2017-12 included the addition of the last-of-layer method to make portfolio fair value hedge accounting more accessible to interest rate risk hedges of portfolios of prepayable financial assets.[27] Prior to ASU 2022-01, GAAP permitted only prepayable financial assets and one or more beneficial interests secured by a portfolio of prepayable financial instruments to be included in a last-of-layer closed portfolio. With ASU 2022-01, entities are now able to include non-prepayable financial assets in a closed portfolio hedged using the portfolio layer method.[28] As a result, entities can apply the same portfolio hedging method to both prepayable and non-prepayable financial assets, meaning that the accounting will be consistent for similar hedges.[29]

These amendments apply to all entities that elect to apply the portfolio layer method of hedge accounting under ASC Topic 815.[30] The amendments apply to public business entities for fiscal years beginning after December 15, 2022, and for interim periods within those fiscal years. For all other entities, the amendments apply for fiscal years beginning after December 15, 2023, and for interim periods within those fiscal years.[31] Early adoption is permitted.[32] Upon adoption, entities have the option to apply the amendments related to disclosures on a prospective basis from the initial application date or on a retrospective basis to each prior period presented after the date of adoption of ASU 2017-12.[33]

2. Update 2022-02—Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures

On March 31, 2022, the FASB issued ASU 2022-02 to respond to feedback gathered during its post-implementation review of its updated credit losses standard, specifically to (a) eliminate the accounting guidance for troubled debt restructuring ("TDRs") by creditors and enhance disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty[34] and (b) require that public business entities

25. *Id.* at 49.
26. Fin. Acct. Standards Bd., Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815) (Aug. 2017) [hereinafter ASU 2017-12].
27. *Id.*
28. ASU 2022-01, *supra* note 24, at 17.
29. *Id.* at 18.
30. *Id.* at 33.
31. *Id.* at 41.
32. *Id.*
33. *Id.*
34. Fin. Acct. Standards Bd., Accounting Standards Update No. 2022-02, Financial Instruments—Credit Losses (Topic 326) 5–44 (Mar. 2022) [hereinafter ASU 2022-02].

disclose current-period gross write-offs by year of origination for financing receivables and net investments in leases.[35]

Prior to the amendments, GAAP included an exception that permitted creditors to record modifications that constitute TDRs in allowance for credit losses upon the modification.[36] This separate guidance has been eliminated.[37] The amendments now require that entities evaluate whether the modification represents a new loan or a continuation of an existing loan, consistent with the accounting for other loan modifications that do not involve TDRs.[38] For public business entities, the amendments also require disclosure of current-period gross write-offs by year of origination for financing receivables and net investment in leases. This disclosure shall be provided in accordance with amended ASC 326-20-50-6, which provides for disclosure of the amortized cost basis of financing receivables by credit quality indicator and class of financing receivable by year of origination.[39]

The amendments go effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, for entities that have adopted the amendments in ASU 2016-13.[40] Early adoption is permitted.[41] For entities that have not yet adopted the amendments in ASU 2016-13, the amendments go effective at the same time as the entity adopts the amendments in ASU 2016-13.[42]

3. Update 2022-03—Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions

On June 30, 2022, the FASB issued ASU 2022-03 to update Topic 820, Fair Value Measurement.[43] The update addresses a divergence in practice that resulted from conflicting guidance in ASC Topic 820 with regard to whether a contractual restriction that prohibits the sale of an equity security should be taken into account when measuring the fair value of that equity security. The update primarily reconciles this conflict, while also introducing new disclosure requirements for equity securities that are subject to contractual sale restrictions that are measured at fair value in accordance with ASC Topic 820.[44] The amendments included in the update affect every entity with investments in equity securities measured at fair value that carry restrictions on sale.

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35. *Id.* at 44–53.
36. *Accounting Standards Codification 310, Receivables*, Fin. Acct. Standards Bd. [hereinafter ASC 310] (para. 310–40, *Troubled Debt Restructurings by Creditors*).
37. ASU 2022-02, *supra* note 34, at 49.
38. *Id.* at 23.
39. *Id.* at 45.
40. *Id.* at 38–39.
41. *Id.*
42. *Id.*
43. Fin. Acct. Standards Bd., Accounting Standards Update No. 2022-03, Fair Value Measurement (Topic 820) (June 2022) [hereinafter ASU 2022-03].
44. *Id.* at 4–9.

The update clarifies that a contractual restriction on the sale of an equity security is not to be considered as part of the unit of account when measuring the fair value of an equity security.[45] The updated standard states, "A contractual sale restriction is a characteristic of the reporting entity holding the security rather than a characteristic of the asset and, therefore, is not considered in measuring the fair value of an equity security . . . ."[46] Furthermore, entities may not recognize and/or measure contractual sale restrictions as a separate unit of account.[47] Where securities are subject to contractual sale restrictions, entities are now required to provide the following disclosures: (a) fair value of such securities reflected in the balance sheet, (b) the nature and remaining duration of restriction(s), and (c) any circumstances that could cause a lapse in such restrictions.[48]

As an illustration, a contractual restriction could be reflected in a lock-up agreement or a market standoff agreement and would not be taken into account in measuring the fair value of an equity security.[49] By contrast, entities would include in the unit of account of an equity security restrictions on resale, such as an inability to resell on a national securities exchange or over-the-counter market equity securities that were originally sold in a private placement, and thus subject to securities law restrictions on resale.[50]

For public business entities, the amendments go effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years.[51] For all other entities, the amendments are effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years.[52] For any entity that is not an investment company under ASC Topic 946, the amendments contained in this update should be applied prospectively and adjustments should be made from the date of the adoption of the amendments. For investment companies under ASC Topic 946, the amendments should be applied to investments that are executed on or after the date of adoption.[53]

4. Update 2022-04—Liabilities—Supplier Finance Programs (Subtopic 405-50): Disclosure of Supplier Finance Program Obligations

On September 29, 2022, the FASB issued ASU 2022-04 to address concerns regarding a lack of transparency and inconsistent presentation of "supplier finance programs," which are also referred to as reverse factoring, payables

45. *Id.* at 5–6.
46. *Id.*
47. *Id.* at 6.
48. *Id.*
49. *Id.* at 8.
50. *Id.* at 7.
51. *Id.* at 8.
52. *Id.* at 9.
53. *Id.*

finance, or structured payables arrangements.[54] These are programs that allow a buyer to offer its suppliers the option to receive payment on invoices ahead of an invoice due date, with such early payments made by a third-party finance provider or other intermediary once the buyer has confirmed the supplier's invoice as valid.[55]

The update adds new ASC Subtopic 405-50, *Liabilities—Supplier Finance Programs*, which requires disclosure of quantitative and qualitative information to allow the user of financial statements to better ascertain the nature and magnitude of any supplier finance program. The new standard employs both prescriptive and principles-based disclosure requirements.[56] For each annual reporting period, the buyer party to a supplier finance program must disclose: (a) key terms of the program, including payment terms, timing, the basis for its determination, and the assets pledged as security or other forms of guarantees provided and (b) the amount of outstanding obligations of the buyer at the end of the reporting period that the buyer has confirmed as valid to the finance provider or intermediary and that remain unpaid by the buyer, along with a rollforward of such obligations since the previous reporting period.[57] During interim periods, the buyer should disclose the confirmed amount of its obligations to the finance provider or intermediary that remains unpaid by the buyer.[58] Such other information shall also be provided, as necessary, to disclose "sufficient information to enable users of financial statements to understand the nature, activity during the period, changes from period to period, and potential magnitude of the entity's supplier finance programs."[59]

The amendments are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, excluding the rollforward information, which is effective for fiscal years beginning after December 15, 2023.[60] Early adoption is permitted.[61] During the fiscal year of adoption, information on the terms of supplier finance programs is to be included in each interim period, notwithstanding the fact that they are annual disclosure requirements.[62] The amendments should be applied retroactively wherever a balance sheet is presented, with the exclusion of the rollforward information.[63]

54. Fin. Acct. Standards Bd., Accounting Standards Update No. 2022-04, Liabilities—Supplier Finance Programs (Subtopic 405-50) (Sept. 2022) [hereinafter ASU 2022-04].
55. *Id.* at 6.
56. *Compare id.* at 7 (ASC 405-50-50-2), with *id.* at 7 (ASC 405-50-50-3).
57. *Id.* at 7–8.
58. *Id.* at 8.
59. *Id.* at 7.
60. *Id.* at 10.
61. *Id.*
62. *Id.* at 8.
63. *Id.* at 10.

5. Update 2022-05—Financial Services—Insurance (Topic 944): Transition for Sold Contracts

On December 15, 2022, the FASB issued ASU 2022-05 to respond to stakeholder feedback regarding ASU No. 2018-12, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI)*.[64] Among other things, ASU 2018-12 required a retroactive transition method to its improvements to the accounting for LDTIs, but did not provide an exception for contracts that had been derecognized due to a sale of one or more such contracts or entities prior to the LDTI effective date.[65]

The update provides that an insurance entity may make an accounting policy election to exclude from the requirements of ASU 2018-12 certain contracts (a) that have been derecognized because of a sale or disposal and (b) for which the insurance entity has no significant continuing involvement.[66] The effect is to reduce implementation costs on the basis that such implementation would not provide useful information to investors or other allocators of capital.[67] Without updated guidance to 2018-12, an insurance entity would be required to reclassify a portion of previously recognized gains or losses due to the adoption of a new accounting standard.[68]

The amendments under this update are effective consistent with the effective dates of the amendments in ASU 2020-11, which, for public business entities that meet the definition of an SEC filer and are not SRCs, are effective for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years.[69] For all other entities, the updated standard is effective for fiscal years beginning after December 15, 2024, and interim periods within fiscal years beginning after December 15, 2025. Early adoption is permitted.[70]

6. Update 2022-06—Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848

On December 21, 2022, the FASB issued ASU 2022-06 to extend the sunset provision contained within ASU No. 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*.[71] ASU 2020-04 provided transition relief for adopting the updated reference rate reform standard, which transition relief included a sunset provision that

64. Fin. Acct. Standards Bd., Accounting Standards Update No. 2022-05, Financial Services—Insurance (Topic 944) (Dec. 2022) [hereinafter ASU 2022-05].

65. Fin. Acct. Standards Bd., Accounting Standards Update No. 2018-12, Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts (Aug. 2018) [hereinafter ASU 2018-12].

66. ASU 2022-05, *supra* note 64, at 3–4.

67. *Id.* at 6.

68. *Id.* at 8.

69. *Id.* at 1, 3.

70. *Id.*

71. Fin. Acct. Standards Bd., Accounting Standards Update No. 2022-06, Reference Rate Reform (Topic 848) (Dec. 2022) [hereinafter ASU 2022-06].

was established with the expectation that the London Interbank Offered Rate ("LIBOR") would cease being published after December 31, 2021.[72] With the announcement that the intended cessation date of USD LIBOR is now June 30, 2023, ASU 2022-06 defers the sunset date under 2020-04 to December 31, 2024, effective immediately upon issuance of ASU 2022-06.[73]

72. Fin. Acct. Standards Bd., Accounting Standards Update No. 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting (Mar. 2020) [hereinafter ASU 2020-04].

73. ASU 2022-06, *supra* note 71, at 3.

Caselaw Developments 2022*

A. Overview

SEC rulemaking and orders. The D.C. Circuit denied a petition challenging a Securities and Exchange Commission ("SEC" or "Commission") order approving fees for wireless services transmitting data from exchanges to market actors, holding that the Commission had jurisdiction over those services;[1] denied a petition challenging SEC approval for a new order type intended to defeat latency arbitrage;[2] granted a petition challenging a consolidated equity market data plan insofar as that plan provided for non-SROs to vote on the plan's operating committee;[3] and denied a petition challenging a new market infrastructure plan that the Commission had designed to foster competition in the provision of proprietary data feeds.[4]

SEC administrative enforcement proceedings—Procedure. The Fifth Circuit held that (i) Commission administrative enforcement proceedings violate respondents' Seventh Amendment jury trial right, (ii) the statute providing the administrative enforcement option violates the Constitution's Article I command that all legislative power rests with Congress because the law grants the Commission carte blanche authority to choose that option over a federal court action, and (iii) the Administrative Law Judge ("ALJ") removal scheme violates the Take Care Clause of Article II because the scheme requires two levels of for-cause removals in order for a President to fire an ALJ.[5] The Fifth Circuit also held that the 2021 amendments to the Securities Exchange Act of 1934 ("Exchange Act") created a new kind of disgorgement in SEC enforcement actions—legal disgorgement under 15 U.S.C. § 78u(d)(3)(A)(ii) and (d)(7)—different from equitable disgorgement under 15 U.S.C. § 78u(d)(5).[6]

SEC enforcement actions—Substance. The Ninth Circuit employed a textual analysis of Exchange Act section 15(a) to affirm summary judgment for the Commission in an action charging the defendants as having acted as

* The caselaw developments cover opinions decided in 2022. 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 31–53 and accompanying text.
2. *See infra* notes 54–74 and accompanying text.
3. *See infra* notes 75–105 and accompanying text.
4. *See infra* notes 106–33 and accompanying text.
5. *See infra* notes 137–63 and accompanying text.
6. *See infra* notes 164–93 and accompanying text.

"brokers," instead of using a multifactor test to reach that conclusion.[7] The Tenth Circuit affirmed summary judgment for the SEC in an action alleging that a CEO made false and misleading statements about the possibility that Apple, Inc. would use his company's technology.[8]

Effect on federal jurisdiction of bylaw choice of forum provision. The Seventh Circuit held that, as applied to prevent a derivative lawsuit in federal court under Exchange Act section 14(a), a bylaw specifying the Delaware Chancery Court as the exclusive forum for a derivative suit violated Delaware General Corporation Law section 115.[9]

Definition of statutory seller for Securities Act section 12 liability in the internet age. The Eleventh Circuit held that a person who encouraged website visitors to buy bitcoins and provided instruction on another website on how to open a bitcoin account could be a soliciting seller under the *Pinter v. Dahl* test and therefore a proper defendant on a Securities Act of 1933 ("Securities Act") section 12 claim.[10] The Ninth Circuit reached the same conclusion as to an individual who promoted an equity fund in an Instagram post and a YouTube video—with both the Eleventh and Ninth Circuits rejecting the argument that solicitation for purposes of identifying section 12 defendants requires personalized, targeted persuasion.[11]

Purchaser/seller rule for standing in private Rule 10b-5 actions. The Second Circuit held that the *Blue Chip Stamp* purchaser/seller requirement for standing to bring a private action under Rule 10b-5 precluded investors who bought the stock of an acquiring company from suing for misstatements made before the merger by and about the target company.[12]

Relationship between the three subparts of Rule 10b-5. The Second Circuit held that, even after *Lorenzo v. SEC*, conduct consisting of no more than making false or misleading statements cannot constitute a Rule 10b-5(a) or (c) violation.[13]

Materiality. The Ninth Circuit found multiple statements to be inactionable puffery in affirming dismissal in a case based on statements about a company's growth in the Chinese market.[14] The Tenth Circuit similarly found most statements about the growth of a company's sales force to be immaterial but reversed dismissal insofar as the action rested on a specific representation about the number of quota-bearing sales personnel.[15]

False or misleading statements. The Fourth Circuit held that plaintiffs attacking a hotel company's statements about cybersecurity failed to plead facts

7. *See infra* notes 196–216 and accompanying text.
8. *See infra* notes 217–55 and accompanying text.
9. *See infra* notes 256–64 and accompanying text.
10. *See infra* notes 270–84 and accompanying text.
11. *See infra* notes 285–301 and accompanying text.
12. *See infra* notes 302–18 and accompanying text.
13. *See infra* notes 319–48 and accompanying text.
14. *See infra* notes 355–74 and accompanying text.
15. *See infra* notes 375–93 and accompanying text.

to show that the statements were false or misleading.[16] The First Circuit found wanting, for the same reason, a complaint challenging an issuer's post-acquisition statements and omissions centering on loss of customers at a business that the issuer had purchased and that it wrote down in steps in the three years after the purchase.[17]

Scienter and scienter pleading. The Fourth Circuit affirmed dismissal of a Rule 10b-5 case alleging that a CEO had falsely represented that his company had a contract—finding insufficient facts in the complaint to raise a strong inference of scienter, where the pled facts showed (i) a lengthy negotiation between the CEO's company and the counterparty, (ii) the counterparty had reported to a public agency that it was going forward with the contract, (iii) the head of the counterparty had signed but not returned the contract, and (iv) the counterparty's board ultimately decided against the deal.[18]

Duty to disclose. In a decision finding one duty to disclose but not another, the Second Circuit reversed dismissal of a Rule 10b-5 action to the extent that the complaint alleged that the issuer had, after reporting a material internal control weakness, failed to disclose an SEC investigation but affirmed to the extent that the complaint alleged that the issuer had not disclosed its role in online articles positive on the issuer's stock.[19] The Ninth Circuit affirmed dismissal of a Rule 10b-5 claim alleging that Twitter did not disclose problems with software prompting users to download advertisers' apps.[20]

Forward-looking statements. The Eleventh Circuit concluded that an issuer's statement that it "believe[d] each year in the U.S. more than 1.4 million people suffer traumatic injuries to peripheral nerves" was forward-looking in context and affirmed dismissal of the Rule 10b-5 action challenging the statement because the complaint did not allege facts to raise the required inference that the issuer made the statement with actual knowledge that it was false or misleading.[21]

Merger disclosures. The Seventh Circuit held that claims under Rule 10b-5 and Securities Act sections 11 and 12 failed to state a claim where the plaintiffs based their action on one merger participant failing to disclose that the other participant was taking an aggressive stance in divestiture negotiations with the government and the merger failed to close.[22]

Life sciences. Finding in each action that the Rule 10b-5 complaints failed to allege falsity and that the district court properly dismissed them, (i) the Second Circuit addressed a case resting on a pharmaceutical company's representation that a clinical trial targeted patients who "strongly" expressed a particular protein;[23] (ii) the Ninth Circuit considered an action in which plaintiffs attacked

16. *See infra* notes 397–414 and accompanying text.
17. *See infra* notes 415–36 and accompanying text.
18. *See infra* notes 437–68 and accompanying text.
19. *See infra* notes 473–85 and accompanying text.
20. *See infra* notes 486–96 and accompanying text.
21. *See infra* notes 497–511 and accompanying text.
22. *See infra* notes 512–31 and accompanying text.
23. *See infra* notes 535–52 and accompanying text.

a company's report of extremely positive results in a Phase 1 trial and later announced much more modest results in a later Phase 1/2 trial;[24] and (iii) the First Circuit ruled on a complaint that a press release announced the *common* adverse side effects suffered in a clinical trial without separately addressing *severe* side effects.[25]

Criminal cases. The Seventh Circuit affirmed the conviction of a CFO on multiple counts where accounting problems were repeatedly brought to his attention by a variety of subordinates in written and oral communications over more than two years and the CFO failed to resolve them.[26]

B. Courts of Appeals

1. SEC Rulemaking and Orders

The D.C. Circuit found the SEC had jurisdiction to regulate the fees of wireless services that were affiliated with exchanges and transmitted data from the exchanges to market participants.[27] That same circuit denied a petition challenging SEC approval of an exchange rule creating a new order type designed to defeat latency arbitrage;[28] granted a petition challenging a consolidated equity market data plan to the extent that the plan provided for voting participation on its operating committee by non-SROs;[29] and denied a petition challenging a new market infrastructure plan designed to foster competition in proprietary data feed services, rejecting exchanges' arguments that the new plan would harm them economically and thereby damage competition.[30]

Regulation of wireless services providing data from exchanges. The Intercontinental Exchange, Inc. ("ICE") owns (i) five exchanges (including the NYSE)—all ICE subsidiaries that are registered with the SEC—and (ii) two ICE subsidiaries that, together with a subsidiary of the NYSE, market data and connectivity services (with the two ICE subsidiaries and the NYSE subsidiary collectively known as ICE Data Services or "IDS").[31] IDS offers two services relevant here—Wireless Bandwidth Connections ("WBC") and Wireless Market Data Connections ("WMDC") (collectively, the "Wireless Connections").[32]

Customers used each of the wireless services for data transmission between a 400,000 square foot building at Mahwah, New Jersey (where the exchanges operate the engines by which they match buyers and sellers) and the customers' own computer equipment at data centers.[33] Market participants using the WMDC service bought data from the exchanges' matching engines directly from the

24. *See infra* notes 553–68 and accompanying text.
25. *See infra* notes 569–95 and accompanying text.
26. *See infra* notes 596–616 and accompanying text.
27. *See infra* notes 31–53 and accompanying text.
28. *See infra* notes 54–74 and accompanying text.
29. *See infra* notes 75–105 and accompanying text.
30. *See infra* notes 106–33 and accompanying text.
31. Intercontinental Exch., Inc. v. SEC, 23 F.4th 1013, 1017 (D.C. Cir. 2022).
32. *Id.* at 1015, 1017–18.
33. *Id.* at 1017–19.

exchanges, and the exchanges sent that data to the IDS equipment in the Mahwah building. IDS then sent the data wirelessly to its equipment in one of the data centers. The IDS equipment there then transferred that data by fiber to the market participant's matching engine equipment also located at the data center.[34]

The WBC service worked in somewhat the same way, but the customers using this service co-located their own equipment in the Mahwah building, with data from an exchange matching engine going into that equipment. The data then traveled inside the Mahwah building to the IDS equipment there, then wirelessly to IDS equipment at a data center, then on by fiber to the customer's equipment co-located at the data center. Importantly, the WBC service provided two-way connectivity so that the market participant could not only receive information from Mahwah but send buy and sell orders from its equipment at a data center to the market participant's equipment co-located at the exchange's premises, from which it could then transfer the orders into an exchange matching engine.[35]

In each case, the wireless connection at issue comprised only a part of the communication chain. But the wireless portions were particularly important "[b]ecause light waves travel faster through air than through fiber-optic cable."[36]

The five exchanges filed the fee schedules for the Wireless Connections "because Commission staff informed them that the Commission viewed the fee schedules as 'rules of an exchange.'"[37] After the SEC issued an order approving the fees, the exchanges petitioned against the order on the ground that "the Wireless Connections 'are not facilities of the Exchange within the meaning of the Act, and therefore do not need to be included in its rules.'"[38]

In denying that petition,[39] the D.C. Circuit found two provisions of the Exchange Act critical.[40] Section 3(a)(1) defines an "exchange" as "any organization, association, or group of persons . . . which constitutes, maintains, or provides a market place or *facilities* for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange."[41] Section 3(a)(2) defines "facility" to "include[]" an exchange's "tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service."[42]

34. *Id.* at 1018 & fig.2.
35. *Id.* at 1018, 1019 fig.3, 1023.
36. *Id.* at 1021.
37. *Id.* at 1020.
38. *Id.* (quoting Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change to Establish a Schedule of Wireless Connectivity Fees and Charges with Wireless Connections, 85 Fed. Reg. 8938, 8939 (Feb. 18, 2020)).
39. *Id.* at 1015, 1028.
40. *Id.* at 1016, 1022–26.
41. *Id.* at 1016 (alteration in original) (emphasis added) (quoting 15 U.S.C. § 78c(a)(1)).
42. *Id.* (quoting 15 U.S.C. § 78c(a)(2)).

First, the panel considered whether the Wireless Connections were "facilities" within the meaning of section 3(a)(2).[43] Then it considered whether, if so, they were part of an exchange within the meaning of section 3(a)(1).[44]

The petitioners argued that neither of the Wireless Connections were "facilities" of an exchange because neither was "directly connected to the Exchanges (i.e., to the matching engines) and are but a single link in the chain of communication between market participants and the matching engines."[45] But the D.C. Circuit found that "the statutory definition of 'exchange' encompasses more than just the matching engine, so there is no reason to think the plain meaning of a system of communication 'to or from the exchange' [in the definition of 'facility'] is limited to a system that provides a direct connection to the matching engine of an exchange."[46] Indeed, the "Wireless Connections are very expensive, highly specialized connections, used exclusively by market participants for the sole purpose of effectuating trading strategies and facilitating market activity [and] . . . are offered by IDS, an affiliate of the Exchanges, and could not exist without the consent of the Exchanges—in other words, they clearly are 'system[s] of communication . . . maintained by or with the consent of the exchange,'" thereby falling within section 3(a)(2)'s definition of "facility."[47]

As the court saw it, that still left the question of whether the Wireless Connections were "the type of facility that Section 3(a)(1) includes in the term 'exchange.'"[48] This issue arose because "the Wireless Connections are provided and maintained by IDS, and not by the Exchanges themselves."[49] Factually, IDS was composed of three companies, two of them subsidiaries of ICE and one (NYSE Technologies Connectivity, Inc.) a subsidiary of the NYSE, which itself was an ICE subsidiary.[50] As a policy matter, there was "a unity of interests between IDS and the Exchanges," and "overlooking corporate affiliation here would allow a company that controls an exchange to evade SEC oversight by making a simple change to its corporate structure; it could then use its control over access to exchange facilities to gain a competitive advantage for its subsidiary, which would be directly at odds with one purpose of the Exchange Act, viz., to prevent the imposition of unnecessary burdens upon competition."[51]

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43. *Id.* at 1022–24.
44. *Id.* at 1024–26.
45. *Id.* at 1022.
46. *Id.* at 1023.
47. *Id.* (citing 15 U.S.C. § 78c(a)(2)). While the petitioners contended that this expansive reading of the statute would submit to SEC regulation, "'telecommunications providers, couriers, or any service used by broker-dealers or others that is somehow related to the later buying and selling of securities on an actual exchange,'" *id.* at 1022–23, the court observed that these means of communication differed from the Wireless Connections because they "do not owe their existence to the consent of any exchange, nor are they maintained by any exchange," *id.* at 1023.
48. *Id.* at 1024.
49. *Id.*
50. *Id.* at 1017 & fig.1, 1024.
51. *Id.* at 1022–25. The court muddles its prose a good deal at this point. The text above attempts to catch the gist.

Statutorily, section 3(a)(1)'s definition of an "exchange" includes a "group of persons . . . which constitutes, maintains, or provides . . . facilities for bringing together purchasers and sellers of securities."[52] That, the court concluded, is exactly the function that the Wireless Connections performed, and "[t]herefore . . . the SEC correctly concluded that the fee schedules for the Wireless Connections are 'rules of an exchange' and hence must be filed with the Commission."[53]

<u>Amended exchange rule permitting form of order designed to defeat loss to latency arbitrage</u>. Rule 611 of Regulation NMS requires securities exchanges to prevent execution of protected trades that are worse for buyers or sellers than the national best bid or offer ("NBBO"), and the NBBO is determined by constant communications between the national exchanges.[54] When a bid that is better than the NBBO comes into one exchange from a buyer or seller, it takes a split second for information about that bid to circulate to the other exchanges and therefore be recognized as the new NBBO.[55] If—in that split second (called "latency")—a trader can learn of the bid when it comes into the exchange on which it is entered (e.g., by a direct data feed from that exchange) and, for example, buy at the older lower NBBO, then immediately sell at the new, higher NBBO once it is recognized as such, then the trader can make a small but sure profit (say, a penny a share) at the expense of the seller to the trader.[56] Such trading is called "latency arbitrage."[57]

Investors Exchange LLC ("IEX") sought to defeat latency trading by (i) forcing all incoming orders to pass through thirty-eight miles of coiled wire to slow their delivery to IEX by 350 microseconds (the "speedbump") and (ii) using a computer algorithm to predict imminent changes in the NBBO (the "crumbling quote indicator" or "CQI").[58] IEX asked the SEC to approve IEX's change of its own rules to recognize as "protected quotations" (which must be "'automated,' publicly displayed, and the [NBBO]") a new type of order by which a customer would authorize IEX to exercise its discretion to alter a limit order price by one tick for two milliseconds when the CQI determined that a change in the NBBO against the customer is imminent.[59] This kind of order (called a "D-Limit order")

52. *Id.* at 1024 (quoting 15 U.S.C. § 78c(a)(1)).

53. *Id.* at 1026.

To the petitioners' argument that the SEC acted arbitrarily and capriciously because it failed to consider whether "subjecting the Wireless Connections to SEC oversight would hamper IDS's ability to compete efficiently," the D.C. Circuit answered that the question of whether the Wireless Connections fell within the SEC's jurisdiction—which was what the petition challenged here—is governed by statute. *Id.* Effect on competition is irrelevant to that jurisdictional issue. *Id.*

54. Citadel Sec. LLC v. SEC, 45 F.4th 27, 30 (D.C. Cir. 2022).

55. *Id.*

56. *Id.* at 30–31.

57. *Id.* at 31.

58. *Id.*

59. *Id.* at 30, 32. *See also* Self-Regulatory Organizations: Investors Exchange LLC; Notice of Filing of Proposed Rule Change to Add a New Discretionary Limit Order Type, 84 Fed. Reg. 71997, 71999–2001 (Dec. 30, 2019). Simple examples showing how the new form of order worked appear at 72000 & nn.41 & 42 (Examples 1, 6).

would thereby be protected from trades at stale prices to high-frequency traders during the latency period.[60]

After the Commission approved the IEX rule change,[61] Citadel Securities LLC—a high-frequency trader—unsuccessfully sought review in the D.C. Circuit.[62] First, Citadel argued that the SEC had no substantial evidence to support its finding "that because the D-Limit order benefits 'all market participants' by 'narrowly' targeting latency arbitrage, it does not unfairly discriminate against liquidity takers or unduly burden competition."[63] The court responded that "[t]he [CQI] turns on for a given security for an average 0.007% of the trading day (about 1.64 seconds)," but that in that very limited time, "24% of IEX's displayed liquidity is traded."[64] This was sufficient evidence "that short-term investors engage in latency arbitrage during the same 'small increments of time' that the [CQI] turns on"[65] and that "the D-Limit order narrowly targets latency arbitrage because IEX changes a price *only* when the crumbling quote indicator turns on."[66]

Second, Citadel complained that the Commission's favorable ruling on the IEX rule change arbitrarily departed from an unfavorable ruling on a proposed rule change by "Cboe EDGA Exchange, Inc., which had sought to impose an all-day, four-millisecond delay on incoming communications from liquidity takers, but not to similarly delay incoming messages from liquidity providers."[67] But the two proposals had differed, as the court saw it—the IEX rule being better

60. *Citadel*, 45 F.4th at 32.

61. *Id.* (citing Investors Exchange LLC; Order Approving a Proposed Rule Change to Add a New Discretionary Limit Order Type Called D-Limit, Exchange Act Release No. 34-89686, 85 Fed. Reg. 54438 (Sept. 1, 2020) [hereinafter IEX Rule Approval]). The order permitted IEX to add subsection (b)(7) to its Rule 11.190. *See* INV. EXCH. LLC, INVESTORS EXCHANGE RULE BOOK r. 11.190(b)(7), at 192–93 (updated through Dec. 9, 2022), https://iextrading.com/docs/Investors%20Exchange%20Rule%20Book.pdf.

62. *Citadel*, 45 F.4th at 29, 38.

63. *Id.* at 32. The Exchange Act only permits "rules" of an exchange that "are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers" and "do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this [Act]." 15 U.S.C. § 78f(b)(5), (8), *quoted in Citadel*, 45 F.4th at 32.

Citadel provided this definition in the context of its discrimination argument:

> As principally relevant here, trading on securities exchanges consists of two sides: (1) those who *post* orders to buy or sell securities on an exchange, known as "liquidity providers," and (2) those who seek to *trade with* a posted order to buy or sell, known as "liquidity takers." This petition challenges an IEX rule that operates during periods of certain price changes to give liquidity providers an automatic, last-microsecond price adjustment that, by design, gives them better pricing at the expense of liquidity takers.

Initial Brief for Petitioner Citadel Sec. LLC, Citadel Sec., LLC v. SEC, 45 F.4th 27 (D.C. Cir. 2022) (No. 20-1424), 2021 WL 533777, at *8. Here, flipping the perspective, Citadel would buy at a stale price and sell at a newer higher price. In both cases, since Citadel was opposite a counterparty that posted an order, Citadel would be a "liquidity taker."

64. *Citadel*, 45 F.4th at 33 (citing IEX Rule Approval, *supra* note 61, at 54440 & n.36).

65. *Id.* (quoting IEX Rule Approval, *supra* note 61, at 54442).

66. *Id.* (emphasis by the court) (quoting IEX Rule Approval, *supra* note 61, at 54449). The panel found these facts also refuted Citadel's contention that "even if the crumbling quote indicator does identify latency arbitrage, the SEC's conclusion that the D-Limit order narrowly targets latency arbitrage was arbitrary and capricious." *Id.* at 32–33.

67. *Id.* at 34–35.

targeted on latency arbitrage because "IEX's delay, by contrast, (1) is 350 microseconds long, which is approximately 1/11th the length of Cboe's delay; (2) applies to incoming communications from both liquidity providers and takers; and (3) permits D-Limit orders to automatically reprice, which occurs during just 0.007% of the trading day."[68]

Third, to be a "protected" bid or offer (the designation that IEX sought from the Commission for its D-Limit orders), the order must be "automated," which in turn meant it must "[i]mmediately and automatically execute[]."[69] Citadel challenged whether the Commission acted arbitrarily and capriciously by finding that the D-Limit order was both.[70] The court found "no serious reason to question the reasonableness" of the SEC conclusion that the D-Limit was automated since "every part" of the order "is automatic" and the "process [by which it operates] involves no manual discretion."[71] While the "immediacy argument" was slightly more complicated, the panel concluded that the SEC "reasonably found [that] an order can be executed 'immediately' even if it is subject to a de minimis delay" and that the "mere 350 microseconds" fell into that category.[72] In response to Citadel's position that the D-Limit order delay could not be "de minimis because it has a substantial effect on the market," the D.C. Circuit answered that the trades with which the D-Limit orders interfere "aren't a normal part of the market."[73] Instead, the SEC reasonably concluded that they "involve latency arbitrage tactics that actually harm the market."[74]

Consolidated Equity Market Data Plan. In 2021, the SEC voted to replace the three existing equity data plans with a Consolidated Equity Market Data Plan (the "Consolidated Equity Plan" or "CT Plan") to "govern[] the public dissemination of real-time consolidated equity market data for national market system ('NMS') stocks."[75] The Consolidated Equity Plan had an overall objective to reduce the information asymmetry between, on the one hand, market participants who rely on the "core data" that the exchanges are required to disseminate to

68. *Id.* at 35.

69. 17 C.F.R. § 242.600(b)(6), (70) (2022). Essentially, the Protected Best Bid and Offer is the NBBO computed without manual quotations. SEC, Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Amend Rule 7.37, Release No. 34-91449, at 2 n.4 (Apr. 1, 2021).

70. *Citadel*, 45 F.4th at 35–36.

71. *Id.* at 36.

72. *Id.* at 36–37 (noting the Commission finding "that D-Limit orders execute 'immediately' because they are subject to only a de minimis delay that does 'not frustrate the purposes of Rule 611 by impairing fair and efficient access to IEX's quotation[s].'" (alteration in original) (quoting IEX Rule Approval, *supra* note 61, at 54447)). Citadel argued that no delay could be permitted where it was deliberate, to which the court responded: "an exchange with *every* intent of delaying communications to its exchange still offers immediate execution if the delay it imposes is so small that it fails to impede fair and efficient market access." *Id.* at 37. Moreover, the delay built into the D-Limit order was "similar to the delay that traders' communications already experience when traveling between various other exchanges across the country." *Id.*

73. *Id.* at 37.

74. *Id.* (citing IEX Rule Approval, *supra* note 61, at 54451).

75. U.S. Sec. & Exch. Comm'n, Joint Industry Plan; Order Approving, as Modified, a National Market System Plan Regarding Consolidated Equity Market Data, 86 Fed. Reg. 44142, 44142 (Aug. 11, 2021) [hereinafter Adopting Release for Consolidated Equity Market Data Plan].

securities information processors ("SIPs"),[76] who then distribute it to subscribers and, on the other hand, market participants who buy "'proprietary data products'"—"exchange-specific data that goes beyond the best bid and best offer quotes contained in the core data feeds and are generally delivered much faster than the core data feeds."[77]

Multiple national stock exchanges challenged the new plan on three bases.[78] First, the Consolidated Equity Plan provided that it would be administered by an operating committee that would include members that were not "self-regulatory organizations" ("SROs"), a set of entities "comprised in large part of the various securities exchanges, including petitioners."[79] The non-SRO members "would include representatives of six classes of equity market participants: institutional investors, broker-dealers with a predominantly retail investor customer base, broker-dealers with a predominantly institutional investor customer base, securities market-data vendors, issuers of NMS stock and retail investors."[80] These members would collectively have one-third of the voting power on the committee.[81] The D.C. Circuit concluded that "the Commission's decision to include representatives of non-SROs on the CT Plan operating committee is unreasonable."[82]

The Commission purported to include these non-SRO members on the basis of its authority under Exchange Act section 11A(a)(3)(B), which gives the SEC the power "by rule or order, to authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under [the Exchange Act] in planning, developing, operating, or regulating a national market system."[83] But the court of appeals found "the Commission's reading of section 11A(a)(3)(B) *both* to expressly identify SROs as those entities that can act jointly in developing and effectuating the national market system *and* to authorize by implication a non-SRO to exercise similar governance authority would render the former superfluous."[84] Moreover, the reference to the SROs "shar[ing]" authority evinces the intent to "share" such authority with entities having "statutory and regulatory obligations" that the non-SROs do not.[85] And, although the Commission pointed also to Section 11A(c)(1)(B)—which provides that "[n]o self-regulatory organization, member thereof, securities information processor,

76. *Id.* There were two SIPs and three equity plans before the Consolidated Equity Plan. *Id.* at 44142 & n.9; Nasdaq Stock Mkt. LLC v. SEC, 38 F.4th 1126, 1132–33 (D.C. Cir. 2022) [hereinafter *Nasdaq 2022 I*]. NASDAQ administered one equity plan, and the NYSE administered the other two. *Id.* at 1133.

77. *Nasdaq 2022 I*, *supra* note 76, 38 F.4th at 1133 (citing Notice of Proposed Order Directing the Exchanges and the Financial Industry Regulatory Authority to Submit a New National Market System Plan Regarding Consolidated Equity Market Data, 85 Fed. Reg. 2164, 2169 (Jan. 14, 2020)).

78. *Nasdaq 2022 I*, *supra* note 76, 38 F.4th at 1131.

79. *Id.* at 1132 (quoted language); *id.* at 1139 (citing 15 U.S.C. § 78c(a)(26)).

80. *Id.* at 1133–34.

81. *Id.* at 1134, 1144.

82. *Id.* at 1139.

83. *Id.* at 1136 (quoting 15 U.S.C. § 78k-1(a)(3)(B)).

84. *Id.* at 1137 (emphasis by the court).

85. *Id.* at 1138.

broker, or dealer shall . . . collect, process, distribute, publish, or prepare for distribution or publication any information with respect to quotations for or transactions in any security . . . in contravention of such rules and regulations as the Commission shall prescribe to . . . assure the prompt, accurate, reliable, and fair collection, processing, distribution, and publication of information with respect to quotations for and transactions in . . . securities"—that language "says nothing about the national market system or its development or operation, [but] merely indicates that non-SROs . . . play enough of a role in the dissemination of market data to warrant granting the Commission antifraud authority to police [them]."[86] Accordingly, "the Commission's decision to include representatives of non-SROs on the [Consolidated Equity] Plan operating committee is unreasonable and therefore invalid."[87]

The petitioners' second challenge attacked a voting protocol that blunts the voting effect of "'exchange groups'—multiple exchanges operating under the same corporate umbrella."[88] Specifically, the Consolidated Equity Plan provided that an SRO not affiliated with another SRO would have one vote on the operating committee, while groups would have one vote collectively, unless the group had "a 'consolidated equity market share' greater than 15%," in which case the group would have two votes.[89] The Commission reasoned that the exchange groups, if each of their members were given a vote, would control much of the voting power by voting as blocks of four or five votes.[90] Since the members of the exchange groups were also the "'primary producers of exchange proprietary data products'"—the outsized voting power of these blocks "would create[] and exacerbate[] conflicts of interests between exchanges' business interests and regulatory obligations under the Exchange Act," with blocks incentivized to vote against improvements in the delivery of core data and expansion of core data content in order to maintain or expand the competitive advantage enjoyed by their proprietary services.[91]

While the challenging exchanges argued that this voting protocol violated the law because section 11A(a)(3)(B) requires all SROs "be on equal terms," the D.C. Circuit held that "nothing in section 11A appears to require the strict one-to-one

86. *Id.* at 1138–39 (alteration in original); 15 U.S.C. § 78k-1(c)(1)(B) (2018).

87. *Nasdaq 2022 I*, *supra* note 76, 38 F.4th at 1139. Doctrinally, the D.C. Circuit placed its analysis in the second step of *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842–43 (1984), bypassing the first step and finding that "even assuming the Commission is correct that section 11A is ambiguous or silent on the issue of non-SRO representation in NMS plan governance [first step], it nevertheless fails to anchor its interpretation to any reasonable reading of section 11A [second step]." *Id.* at 1136, 1139.

88. *Id.* at 1133.

89. *Id.* at 1134. For example, "the SROs under the NYSE's umbrella—New York Stock Exchange LLC, NYSE American LLC, NYSE Arca, Inc., NYSE Chicago, Inc., and NYSE National, Inc.—would be treated as one SRO Group and receive two votes, instead of receiving one vote for each SRO." *Id.*

90. *Id.* at 1133.

91. *Id.* (quoting Notice of Proposed Order Directing the Exchanges and the Financial Industry Regulatory Authority to Submit a New National Market System Plan Regarding Consolidated Equity Market Data, 85 Fed. Reg. 2164, 2170 (Jan. 14, 2020)).

voting representation by individual SROs."[92] In particular, the section's reference to "act[ing] jointly" "simply means to act cooperatively, together or in conjunction . . . [and] does not require a particular level of involvement among the individual members—such as 'one SRO, one vote,' as petitioners seem to suggest—so long as all participants are involved to some degree."[93] Although the petitioners contended that the voting structure "subjects affiliated SROs to less favorable treatment than unaffiliated SROs, without adequate explanation," the court of appeals held that the Commission had provided such an explanation by "citing the need to mitigate the Equity Data Plans' practical dilution of unaffiliated exchanges' voting power," subjecting them to outsized influence by a small number of exchange groups whose sale of proprietary data products created a conflict of interest when considering upgrades to core data delivery and content.[94]

Third, the challengers contested the Consolidated Equity Plan's requirement that the plan have an "independent administrator"—"meaning 'not . . . owned or controlled by a corporate entity that, either directly or via another subsidiary, offers for sale its own [proprietary-data products].'"[95] The petitioning exchanges contended that this provision arose from the SEC's "'purely theoretical' concern that a CT Plan administrator could misappropriate confidential information"—which the SEC did not support either by pointing to a current or past equity plan administrator committing such misconduct or by describing "shortcomings of existing safeguards."[96] But the D.C. Circuit found that (i) the Commission had "highlighted a plausible conflict of interest: the potential misuse of 'sensitive SIP customer information of significant commercial value' by administrators that sell competing market data products," and (ii) it was "of little consequence" that "the Commission's conflict of interest worry has not yet manifested itself . . . , as an agency has the latitude to 'adopt prophylactic rules to prevent potential problems before they arise'—that is, '[a]n agency need not suffer the flood before building the levee.'"[97]

The petitioners also pointed to the oddity that while the new plan would exclude an SRO that offered proprietary data products from serving as the administrator, it would permit selection of an administrator that was not an SRO but that sold market data, even though such a non-SRO "could have similar conflicts of interest."[98] But the court ruled that the SEC was not required to address all conflicts rather than attack targeted ones and that, in any event, the SROs on

92. *Id.* at 1140.

93. *Id.*

94. *Id.* at 1141–42.

95. *Id.* at 1142 (alteration in original) (quoting Adopting Release for Consolidated Equity Market Data Plan, *supra* note 75, at 44195). This "would preclude both of the current Equity Data Plan administrators—the NYSE and Nasdaq—from subsequently serving as the CT Plan administrator." *Id.* at 1134.

96. *Id.* at 1142.

97. *Id.* at 1142–43 (quoting Stilwell v. Off. of Thrift Supervision, 569 F.3d 514, 519 (D.C. Cir. 2009)).

98. *Id.* at 1143.

the operating committee would "have 'sufficient voting power' and 'incentive' to ensure that any non-SRO chosen to serve as administrator 'would [not] face a financial conflict of interest and act as a direct competitor to the SROs' proprietary data business.'"[99] As to the contention that the independence requirement would prevent either the Nasdaq or NYSE from serving as the administrator under the new plan and thereby forfeit the opportunity to make use of the institutional knowledge they had gained by acting as the administrators of the preceding equity market data plans, the D.C. Circuit found that the Commission had considered this cost and concluded that elimination of the inherent conflicts outweighed it.[100]

Having thereby determined that the provision requiring non-SROs to serve on the Consolidated Equity Plan's operating committee exceeded the Commission's authority, that the provision allocating voting rights on that committee so as to limit the power of exchange groups was neither contrary to law nor arbitrary and capricious, and that the provision requiring an independent administrator was not arbitrary and capricious,[101] the D.C. Circuit turned to disposition.[102] Ruling that the illegal addition of non-SROs to the Consolidated Equity Plan's operating committee was not separable from the plan as a whole, the panel granted the petitions for review to the extent they rested on that challenge and vacated the Consolidated Equity Plan order in its entirety.[103]

Significance and analysis. Putting aside the technicalities of market data distribution, the idea that the Commission can avoid arbitrary and capricious challenges by pointing to a "plausible" conflict of interest (here on the part of a plan administrator that might misappropriate confidential information to exploit for its own profit) without empirical support (nothing to show that the administrators of the existing plans—NASDAQ and an NYSE subsidiary—had done so) and that elimination of this "plausible" conflict outweighs acknowledged costs (such as the loss of the current administrators' experience) raises serious questions.[104] It suggests that the Commission can adopt virtually any rule within

99. *Id.* at 1143 (alteration in original) (quoting Adopting Release for Consolidated Equity Market Data Plan, *supra* note 75, at 44197).

100. *Nasdaq 2022 I*, *supra* note 76, 38 F.4th at 1143–44.

101. *Id.* at 1135.

102. *Id.* at 1144–45.

103. *Id.* at 1145.

The Commission had preceded the order adopting the new plan with a so-called Governance Order that required the exchanges and FINRA to prepare and submit a Consolidated Equity Plan containing the three features discussed above. Order Directing the Exchanges and the Financial Industry Regulatory Authority to Submit a New National Market System Plan Regarding Consolidated Equity Market Data, 85 Fed. Reg. 28702 (May 13, 2020). When the exchanges challenged that earlier order, the D.C. Circuit ruled that the challenge was premature because the Governance Order was not a "final order" but only one to submit a plan that would then itself be subject to comment and revision before adoption. Nasdaq Stock Mkt. LLC v. SEC, 1 F.4th 34 (D.C. Cir. 2021). The 2022 opinion nevertheless addressed that Governance Order by "vacat[ing] only those portions authorizing the invalid non-SRO representation, leaving the remainder of the Governance Order intact." *Nasdaq 2022 I*, *supra* note 76, 38 F.4th at 1145.

104. The Commission concluded that an SRO administering the Consolidated Equity Plan might misappropriate information it gained as such an administrator to gain a competitive advantage in

its legal authority simply because SEC lawyers conjure a possible justification and put it down in prose. Such a scenario recalls the scholarly criticism of "quack" lawmaking in the early part of this century that rested on hypotheticals that made sense to lawyers but lacked empirical justification.[105]

New Market Infrastructure Plan. In a second market data distribution decision, the D.C. Circuit considered challenges by exchanges to a Market Infrastructure Plan ("Infrastructure Plan") the SEC adopted in 2021.[106] The Commission adopted the Infrastructure Plan out of concern that market participants faced a two-tier information choice.[107] First, a participant could subscribe to a core data feed, provided to subscribers through two exclusive securities information processors that obtained raw information directly from exchanges and compiled it for transmission.[108] That core data was limited to "(1) the price and size of the last sale and the exchange on which the sale took place; (2) each exchange's current highest bid and lowest offer, and the number of shares available at those prices; and (3) the national highest bid and lowest offer for each stock on any exchange."[109] Second, a market participant could subscribe, for a higher price, to proprietary data feeds developed and marketed by the exchanges that "deliver data to subscribers much faster than the core data feeds" and that "may also contain much more detailed information about the range of transactions taking place on the exchanges, rather than just the best bid and best offer quotes."[110]

The Infrastructure Plan expands "core data" to include additional information, such as depth of book.[111] The plan also "compels the exchanges to distribute" "underlying trading data" "to competing data consolidators for a fee set by a committee, consisting of the exchanges and other major market players and approved by the Commission," so that those "competing consolidators, who must register with the Commission, may develop different kinds of data feeds

developing and marketing its own (or an affiliate-owned) proprietary data service. *Nasdaq 2022 I*, *supra* note 76, 38 F.4th at 1142. Nothing showed that the NYSE or Nasdaq had done so when acting as administrators of the existing equity data distribution plans, but the agency skated by on "plausibility" of such misuse as well as its long experience supervising the industry and industry comments supporting the separation of the plan administrator's regulatory responsibilities from an exchange's commercial interests. *Id.* at 1142–43.

105. *See*, famously, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

106. Nasdaq Stock Mkt. LLC v. SEC, 34 F.4th 1105 (D.C. Cir. 2022) [*Nasdaq 2022 II*]; U.S. Sec. & Exch. Comm'n, Market Data Infrastructure, 86 Fed. Reg. 18596 (Apr. 9, 2021) [Infrastructure Plan]. The plan was embodied in revisions to various regulations, particularly in 17 C.F.R. §§ 242.600, .603, .614.

107. *Nasdaq 2022 II*, *supra* note 106, 34 F.4th at 1106–07.

108. *Id.* at 1106.

109. *Id.*

110. *Id.* at 1107.

111. Infrastructure Plan, *supra* note 106, at 18602 (new rule would include "depth of book" data, which includes "information about quotations that are outside of the best-priced quotations"); *Nasdaq 2022 II*, *supra* note 106, 34 F.4th at 1107. As an example, where a seller wants to sell more shares than buyers are willing to buy at the national best bid, depth of book permits the seller to see the price that the seller could get for the additional shares.

in accordance with market demand based on the varied needs of investors."[112] The plan further "permit[s] market participants to 'self-aggregat[e]' by purchasing raw data directly from the exchanges and consolidating it for their own internal use."[113] The overall goal is to reduce information asymmetry between market participants and encourage the development and sale of a wide range of data feeds to meet the needs and budgets of different investors.[114]

Exchanges challenged the Infrastructure Plan as (i) arbitrary and capricious and on the basis that (ii) the Commission adopted the plan without accounting for a variety of adverse outcomes, thereby "violating its statutory duties to weigh the Rule's economic impacts, to protect investors and the public interest, and to promote the fair collection and distribution of market data."[115] The D.C. Circuit rejected all these arguments and denied the exchanges' petitions.[116]

The exchanges offered two contentions to support their position that SEC adoption of the plan was arbitrary and capricious.[117] First, they averred that the plan would not reduce information asymmetries but simply turn a two-tiered system into a multitiered one, but the court responded that "the Commission aimed not to require that every market participant have access to the same data at the same speed, but rather to address a dearth of options for consumers with widely divergent data needs in the existing marketplace."[118] Second, the exchanges argued that the "Rule rests on speculation"—about the number of new entrants into the market for data distribution and the number of institutions that would decide to self-aggregate.[119] But the court of appeals answered that, while "there was some uncertainty about the number of entrants to the market," the

112. *Nasdaq 2022 II*, *supra* note 106, 34 F.4th at 1107. Among other things, this meant that the two SIPS would no longer be the exclusive channel by which core data was consolidated and distributed to market participants.

113. *Id.* (quoting Infrastructure Plan, *supra* note 106, at 18602).

114. *Id.* at 1107, 1108.

115. *Id.* at 1106, 1111.

116. *Id.* at 1106, 1114. The Exchanges had filed a petition to challenge the Infrastructure Plan even before it was adopted, but the D.C. Circuit dismissed that petition as premature. *Id.* at 1107. In the decision summarized above, the court substantively addressed a second petition, filed after the Commission adopted the plan and, consolidating that petition and the earlier one, denied them both. *Id.* at 1107, 1114.

117. *Id.* at 1108–11.

118. *Id.* at 1109. The exchanges also argued that the plan's "allowance for large firms to 'self-aggregate' data for internal use" would "exacerbate information asymmetries," allowing the large firms to "gain[] an additional speed advantage over all other market participants" by "purchasing raw data directly from the exchanges and aggregating it for their own internal use, rather than purchasing a prepackaged data product from one of the competing consolidators." *Id.* The panel brushed this aside with the comment that "[p]etitioners have not explained why any latency advantages enjoyed by self-aggregators would be more significant under the new Rule than the previous regime." *Id.* And while the exchanges contended that, with fragmented data distribution through multiple providers, the new system will "actually be more prone to disruptions . . . because each competing consolidator would represent a single point of failure with respect to its own customers," the court concluded this argument failed to appreciate the Commission's conclusion that the new system will "'improve the resiliency of the *national market system*' as a whole" and was not intended to "guarantee that individual consumers could never experience outages or disruptions." *Id.* (emphasis by the court) (quoting Infrastructure Plan, *supra* note 106, at 18661).

119. *Id.* at 1108, 1109–10.

Commission had engaged in an elaborate analysis including "the barriers to entry for would-be competing consolidators; the anticipated fees to be charged for the underlying data the consolidators would purchase, aggregate, and sell; the fixed 'connectivity' costs to competing consolidators, i.e., the fees charged to cover the cost of transmitting the underlying data to the competing consolidators; the anticipated demand for the competing consolidators' data products; and the competing consolidators' ability to offer differentiated data products."[120] That analysis was enough[121] to show that the SEC had "'considered the relevant factors and "articulate[d] a rational connection"'" between the facts considered and the prediction it made.[122]

Addressing four arguments the petitioners raised contesting the Infrastructure Plan as inconsistent with the Commission's statutory objectives to protect investors and promote competition, the court turned first to the exchanges' position that the SEC had failed to reasonably conclude that the new plan would not adversely affect "the availability of a single, reliable 'national best bid and offer' quote to the detriment of retail investors."[123] This argument rested on the prediction that the many different data vendors the plan contemplates would produce different best bids and offers, thus destroying the uniformity of the NBBO numbers that ensure that retail sellers and buyers have their order executed at the most favorable prices.[124] The D.C. Circuit answered that the Commission had recognized that, with the multiple data vendors already operating under the superseded data distribution plans, such "fragmentation already exists . . . [with] some market participants rely[ing] on the national best bid and offer as calculated by the exclusive processors, while others 'calculat[e] their own version by aggregating petitioners' faster proprietary-data feeds or hiring a third-party vendor to aggregate the data for them.'"[125] The exchanges did "not explain[] how the national best bid and offer quote would be appreciably more fragmented under the new Rule than it is under the current regime."[126]

Second, the exchanges contended that the new plan "undermine[s] . . . [their] incentive to invest in . . . innovative data products," thereby harming competition that would in turn harm investors.[127] But this argument, the court of appeals concluded, focused narrowly on the exchanges' own incentives and future actions, whereas the Commission was attempting to foster competition throughout the data distribution system as a whole that "would promote innovation in

120. *Id.* at 1110 (citations omitted to Infrastructure Plan, *supra* note 106).

121. *Id.*

122. *Id.* at 1108 (quoting AT&T Corp. v. FCC, 220 F.3d 607, 616 (D.C. Cir. 2000) (quoting Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983))). In fact, the opinion says that "'when an agency's decision is primarily predictive . . . [the court] require[s] only that the agency acknowledge factual uncertainties and identify the considerations it found persuasive.'" *Id.* at 1110 (alteration in original) (quoting Am. Hosp. Ass'n v. Azar, 983 F.3d 528, 536 (D.C. Cir. 2020) (quoting Rural Cellular Ass'n v. FCC, 588 F.3d 1095, 1105 (D.C. Cir. 2009))).

123. *Id.* at 1111–12.

124. *Id.* at 1112.

125. *Id.* (quoting SEC Brief (citing Infrastructure Plan, *supra* note 106, at 18657)).

126. *Id.*

127. *Id.*

[that] broader data market and is designed to encourage a proliferation of new data products."[128]

Third, the exchanges contended that the Infrastructure Plan would also harm competition because it would reduce their revenues from their own proprietary data products, thereby weakening their ability to compete with off-exchange venues, increasing the proportion of trades on those darker trading platforms, and ultimately "reduc[ing] transparency in the marketplace as a whole," but here again the court found that the exchanges were conflating their own position with that of the market overall.[129] The fact that the plan might hurt them did not mean that the plan would not encourage competition in market data distribution in the aggregate.[130] Moreover, the SEC had no obligation "to quantify each individual exchange's anticipated revenue" loss.[131]

Fourth, the exchanges averred more generally that their losing profits would produce "downstream harm" because that loss would "cripple their reinvestment in their own products" and limit their ability to fulfill their statutory duties.[132] The court countered that funding for product development was "not limited to . . . internal cash-on-hand" because, "like any business, the exchanges can obtain external funding for promising opportunities to develop new products in the future" and any "notion that any reduction in revenue would necessarily compromise the exchanges' bottom line so severely as to affect their ability to comply with their regulatory responsibilities is unsubstantiated."[133]

2. SEC Administrative Enforcement Proceedings—Procedure

Federal law permits the SEC to pursue enforcement actions in either federal court or before its own administrative law judges ("ALJs"), with remedies in both fora including prohibitions (in the form of injunctions in court and cease-and-desist orders in administrative proceedings), disgorgement, officer and director bars, and civil penalties.[134] In 2022, the Fifth Circuit rendered an opinion throwing into doubt the future of the administrative proceeding option, holding that (i) administrative proceedings violated respondents' Seventh Amendment right to a jury trial, (ii) the statute giving the SEC the unguided discretion to proceed against a putative securities law violator either in federal court or by administrative enforcement violated the U.S. Constitution's Article I provision resting "all" legislative power in Congress, and (iii) the double for-cause layers insulating the SEC ALJs from removal violated the Take Care Clause of Article II.[135] The Fifth Circuit also

128. *Id.*
129. *Id.* at 1112–13.
130. *Id.* at 1113.
131. *Id.* ("[A]ny losses may be partially or fully offset by the fees paid to exchanges by competing consolidators for their data and by the opportunity for the exchanges to continue to sell some version of their existing proprietary data products.").
132. *Id.* at 1113–14.
133. *Id.* at 1114.
134. 15 U.S.C. § 78u(d) (2018) (federal court actions); *id.* §§ 78u-2, 78u-3 (administrative proceedings).
135. *See infra* notes 137–63 and accompanying text.

held that, with amendments to the SEC's enforcement powers in 2021, Congress created a new "legal" disgorgement in 15 U.S.C. § 78u(d)(3)(A)(ii) and (d)(7)—different from "equitable" disgorgement in 15 U.S.C. § 78u(d)(5)—and affirmed the disgorgement in the case before it as permitted by the recent amendment.[136]

Administrative enforcement proceedings and right to jury trial, delegation by Congress of unrestricted discretion to choose between federal lawsuit and administrative proceeding, and double-layer for-cause removal protection for ALJs. The SEC filed an administrative enforcement proceeding against George Jarkesy and an investment advisor to two hedge funds that Jarkesy had established.[137] An SEC ALJ found that the respondents had committed securities fraud and, on review, the SEC agreed; the Commission (i) imposed a cease-and-desist order against further violations, (ii) ordered the investment advisor to disgorge $685,000, and (iii) barred Jarkesy from (a) associating with brokers, dealers, or investment advisors, (b) offering penny stocks, and (c) serving as an officer or director of a fund advisory board or as an investment adviser.[138] The Commission also imposed a $300,000 civil penalty, for which both Jarkesy and the investment advisor were jointly and severally liable.[139]

In 2022, the Fifth Circuit granted the respondents' petition for review and vacated the SEC's decision[140] on three bases: "(1) the SEC's in-house adjudication of Petitioners' case violated their Seventh Amendment right to a jury trial; (2) Congress unconstitutionally delegated legislative power to the SEC by failing to provide an intelligible principle by which the SEC would exercise the delegated power [to proceed by court action or administrative proceeding], in violation of Article I's vesting of 'all' legislative power in Congress; and (3) statutory removal restrictions on SEC ALJs violate the Take Care Clause of Article II."[141]

As to jury trial, the court of appeals reasoned that the Seventh Amendment right extends to "all actions akin to those brought at common law as those actions were understood at the time of the Seventh Amendment's adoption."[142] "Whether Congress may properly assign [such] an action to administrative adjudication [and thereby foreclose a jury] depends on whether the proceedings

136. *See infra* notes 164–93 and accompanying text.

137. Jarkesy v. SEC, 34 F.4th 446 (5th Cir. 2022), *rehearing en banc denied*, 51 F.4th 644 (5th Cir. 2022), *docketing petition for cert.,* No. 22-991 (Apr. 12, 2023).

138. *Id.* at 450. While the enforcement proceeding was underway, the Supreme Court decided in *Lucia v. SEC*, 138 S. Ct. 2044, 2054–55 (2018), that the manner in which the Commission chose its ALJs violated the Appointments Clause of the U.S. Constitution. *Jarkesy*, 34 F.4th at 450. The SEC then reassigned the enforcement proceeding to a properly appointed ALJ, but Jarkesy and the investment advisor elected to continue with what was at that time their petition to the Commission from the original ALJ ruling without a new hearing. *Id.*

139. *Jarkesy*, 34 F.4th at 450; John Thomas Cap. Mgmt. Grp. LLC, D/B/A Patriot 28 LLC; and George R. Jarkesy, Jr., Securities Act Release No. 10834, 2020 WL 5291417, at *29 (Sept. 4, 2020) (sanctions).

140. *Jarkesy*, 34 F.4th at 449–50, 466.

141. *Id.* at 449.

142. *Id.* at 452 (citing Tull v. United States, 481 U.S. 412, 417 (1987)).

center on 'public rights.'"[143] And whether such an assignment is proper depends on "(1) whether 'Congress "creat[ed] a new cause of action, and remedies therefor, unknown to the common law," because traditional rights and remedies were inadequate to cope with a manifest public problem'; and (2) whether jury trials would 'go far to dismantle the statutory scheme' or 'impede swift resolution' of the claims created by statute."[144]

Pursuing this analysis, (i) "[f]raud prosecutions were regularly brought in English courts at common law," including those to "'make the defendant liable in strictness to pay a fine to the king, as well as damages to the injured party'";[145] and (ii) jury trials would not dismantle the federal regulation of securities or interfere with swift disposition of Commission cases since the securities statutes expressly permit the SEC to bring such cases in federal court and the Commission "has in fact brought many such actions to jury trial over the years."[146] Accordingly, Jarkesy and the investment advisor to the hedge funds had a constitutional right to a jury trial "to adjudicate the facts underlying any potential fraud liability that justifies [civil] penalties."[147] Moreover, that right extended to the questions of fact that underlay the equitable relief that the Commission had sought, where those same questions underlay the legal relief.[148] By filing the enforcement proceeding administratively, the SEC stripped the defendants of their right to a jury trial and thereby violated their Seventh Amendment rights.[149]

Turning next to whether the statutory scheme—permitting the Commission to choose between filing an enforcement action in federal court or before the SEC's ALJs—amounted to an unconstitutional delegation of legislative power to the executive branch,[150] the Fifth Circuit observed that "Article I of the Constitution . . . provides that '*[a]ll* legislative Powers herein granted shall be vested in a Congress of the United States.'"[151] And "power to assign disputes to agency adjudication is 'peculiarly within the authority of the legislative department.'"[152] Congress may delegate that power "only if it provides an 'intelligible principle' by which the recipient of the power can exercise it."[153]

Here, Congress "gave the SEC the ability to determine which subjects of its enforcement actions are entitled to Article III proceedings with a jury trial,

143. *Id.* at 453 (citing Atlas Roofing Co. v. Occupational Safety & Health Rev. Comm'n, 430 U.S. 442, 450 (1977)).

144. *Id.* (quoting Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 60–63 (1989) (quoting *Atlas Roofing*, 430 U.S. at 454 n.11)).

145. *Id.* at 453–54 (quoting 3 William Blackstone, Commentaries on the Laws of England *42 (Oxford, Clarendon Pr. 1992) (1765)); *id.* at 455 ("[F]raud actions under the securities statutes echo actions that historically have been available under the common law.").

146. *Id.* at 455–56.

147. *Id.* at 457.

148. *Id.* at 454.

149. *Id.* at 459.

150. *Id.* at 469–63.

151. *Id.* at 460 (emphasis by the court) (quoting U.S. Const. art. I, § 1).

152. *Id.* at 460–61 (quoting Oceanic Steam Navigation Co. v. Stranahan, 214 U.S. 320, 339 (1909)).

153. *Id.* (quoting Mistretta v. United States, 488 U.S. 361, 372 (1989) (quoting J.W. Hampton, Jr. & Co. v. United States, 276 U.S. 394, 409 (1928))).

and which are not. That was a delegation of legislative power."[154] Since "[e]ven the SEC agrees that Congress has given it exclusive authority and absolute discretion to decide whether to bring securities fraud enforcement actions within the agency instead of in an Article III court" and "said nothing at all indicating how the SEC should make that call in any given case," the grant was made without an intelligible principle of how that discretion was to be exercised and, accordingly, was constitutionally impermissible.[155]

Moving finally to whether the scheme for removal of ALJs violates the Constitution, the Fifth Circuit began with the constitutional requirement "that the President must 'take Care that the Laws be faithfully executed.'"[156] In order to discharge this duty, "the President must have adequate power over officers' appointment and removal."[157] The Supreme Court ruled in *Free Enterprise Fund v. Public Co. Accounting Oversight Board* that the PCAOB statute violated the Take Care clause because (i) only the SEC could remove Board members and only then "for 'willful violations of the [Sarbanes–Oxley] Act, Board rules, or the securities laws; willful abuse of authority; or unreasonable failure to enforce compliance—as determined in a formal Commission order, rendered on the record and after notice and an opportunity for a hearing'"; and (ii) the President "could only remove SEC Commissioners for 'inefficiency, neglect of duty, or malfeasance in office.'"[158] The Court held that these two stacked for-cause protections "insulating PCAOB members from removal deprived the President of the ability to adequately oversee the Board's actions," as the Take Care clause required him to do.[159]

Similarly here, the "SEC ALJs may be removed by the Commission 'only for good cause established and determined by the Merit Systems Protection Board (MSPB) on the record after opportunity for hearing before the Board[,]' . . . [a]nd the SEC Commissioners may only be removed by the President for good cause."[160] Accordingly, "SEC ALJs are sufficiently insulated from removal that the President cannot take care that the laws are faithfully executed" and the statutes creating the double for-cause layers "are unconstitutional."[161]

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154. *Id.* at 461.
155. *Id.* at 462.
156. *Id.* at 463 (quoting U.S. Const. art. II, § 3).
157. *Id.* (citing Myers v. United States, 272 U.S. 52, 117 (1926)).
158. *Id.* (quoting Free Enter. Fund v. Pub. Co. Acct. Oversight Bd., 561 U.S. 477, 486–87, 503 (2010)).
159. *Id.*
160. *Id.* at 464 (quoting 5 U.S.C. § 7521(a)).
161. *Id.* at 456.

The Fifth Circuit panel split two to one, with the dissenting judge disagreeing with the majority on all three legal issues. *Id.* at 466–79 (Davis, J., dissenting). He sided with "sister circuits" holding that "an enforcement action by the Government for violations of a federal statute or regulation is a 'public right' that Congress may assign to an agency for adjudication without offending the Seventh Amendment." *Id.* at 468 & n.20 (citing cases). The dissenter rejected the conclusion that giving the SEC the authority to choose to bring enforcement proceedings in either federal district court or before the Commission's ALJs amounted to an unconstitutional delegation of legislative power, reasoning that that power was no more legislative than the routine power of prosecutors "to decide between two criminal statutes that provide for different sentencing ranges for essentially the same conduct." *Id.* at 474. As for the Take Care clause, the dissenting judge distinguished the PCAOB members that

Significance and analysis. Lay controversy over what some call the "administrative state" flourishes, with some arguing that vast bureaucracies now essentially make laws and then enforce them through their own internal "court" systems—all without accountability to the voting public and even without effective control by either Congress or the President.[162] Legal battles on this idea have played out in securities cases.[163] Perhaps this will prove a benefit, nudging the administrative state discussion away from such fraught subjects as immigration, pandemic responses, and student loan forgiveness and thereby encouraging more dispassionate discourse.

Creation of "legal" disgorgement by 2021 Exchange Act amendments—15 U.S.C. § 78u(d)(3)(A)(ii) and (d)(7). In 1971, the Second Circuit held that the SEC could seek "'restitution of profits'" in enforcement actions, finding the authority to award it "in the 'general equity power' conferred by the Exchange Act."[164] One year later, that court referred to such relief as requiring a wrongdoer to "disgorge" profits.[165] Seventeen years thereafter, the D.C. Circuit adopted a burden-shifting rule, ultimately accepted in all other circuits, by which the government has the initial burden of proving up "an amount [that] reasonably approximated a defendant's unlawful gain," which the defendant can then challenge "by demonstrating 'a clear break in or considerable attenuation of the causal connection between the illegality and the ultimate profits,'" with opinions subsequently holding that a district court's ultimate decision on the amount is reviewable only for abuse of discretion.[166]

In 2002, the Sarbanes-Oxley Act amended the Exchange Act to include 15 U.S.C. § 78u(d)(5): "In any action or proceeding brought . . . [by the SEC] under any provision of the securities laws, [the SEC] may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors."[167]

In 2017, the Supreme Court's *Kokesh v. SEC* decision held that, "as it is applied in SEC enforcement proceedings," disgorgement was a penalty subject to the five-year statute of limitations for penalties.[168] In its 2020 *Liu v. SEC* opinion, the Supreme Court observed that *Kokesh* "evaluated a version of the SEC's

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the Court considered in *Free Enterprise* from the SEC's ALJs because the former exercise executive power while the latter exercise only adjudicative power. *Id.* at 475–79.

162. *See, e.g.*, John Tierney, *The Tyranny of the Administrative State*, WALL ST. J. (June 9, 2017), https://www.wsj.com/articles/the-tyranny-of-the-administrative-state-1497037492; Editorial, *Administrative State Under Judicial Fire*, WALL ST. J. (Sept. 19, 2019), https://www.wsj.com/articles/administrative-state-under-judicial-fire-11568929932.

163. *See* Lucia v. SEC, 138 S. Ct. 2044 (2018); *Free Enterprise*, 561 U.S. 477; Cochran v. SEC, 20 F.4th 194 (5th Cir. 2021) (en banc) (particularly the concurrence by Judge Oldham, *id.* at 213–36), *aff'd,* Axon Entr., Inc. v. FTC, 143 S. Ct. 890 (2023); and now *Jarkesy*. Other substantive areas have seen important legal decisions implicating the administrative state. *See* most notably West Virginia v. Envt'l Protection Agency, 142 S. Ct. 2587 (2022).

164. SEC v. Hallam, 42 F.4th 316, 327 (5th Cir. 2022) (quoting SEC v. Tex. Gulf Sulphur Co., 446 F.2d 1301, 1307 (2d Cir. 1971)).

165. *Id.* at 328 (quoting SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1103 (2d Cir. 1972)).

166. *Id.* at 329 (quoting SEC v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989)).

167. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 305(b), 116 Stat. 745, 778–79 (2002).

168. Kokesh v. SEC, 137 S. Ct. 1635, 1645 (2017).

disgorgement remedy that seemed to exceed the bounds of traditional equitable principles," and that, as properly bounded, equitable disgorgement must be limited to "net profits,"[169] calculated to "deduct legitimate expenses before ordering disgorgement."[170] The Court also held that wide-ranging joint and several liability is inconsistent with proper limits on disgorgement, but that collective liability could reach "partners in wrongdoing,"[171] and suggested that disgorgement recovery under 15 U.S.C. § 78u(d)(5) might—in order to fit within the statutory limits—have to be returned to victims instead of being deposited into the U.S. Treasury or some fund for whistleblower awards and the SEC's Inspector General.[172]

In 2021, Congress amended the Exchange Act again.[173] The amendments (i) expressly conferred on district courts, by 15 U.S.C. § 78u(d)(3)(A)(ii), jurisdiction "'to . . . require disgorgement under paragraph (7) . . . of any unjust enrichment by the person who received such unjust enrichment as a result of [an Exchange Act] violation'"; (ii) provided in 15 U.S.C. § 78u(d)(7) that "'[i]n any action or proceeding brought by the [SEC] under any provision of the securities laws, the [SEC] may seek, and any Federal court may order, disgorgement'"; (iii) established by 15 U.S.C. § 78u(d)(8)(A) a five- or ten-year limitations period for "'disgorgement,'" depending on whether the underlying securities law violation required scienter, while setting a ten-year period for "'any equitable remedy'"; and (iv) mandated that all these amendments would apply not only to new cases but also to actions pending on the date the amendments were enacted.[174]

Last year, the Fifth Circuit struggled to make sense of this history in *SEC v. Hallam* and, in the process, identified two different SEC disgorgement remedies.[175]

Two members of the Fifth Circuit panel differentiated between what they called "legal disgorgement," permitted by 15 U.S.C. § 78u(d)(3)(A)(ii) and (d)(7), and "equitable disgorgement," permitted by 15 U.S.C. § 78u(d)(5)—the statute interpreted by *Liu*.[176] This majority declined to decide "whether equitable disgorgement

169. 140 S. Ct. 1936, 1946 (2020).

170. *Id.* at 1950.

171. *Id.* at 1949.

172. *Id.* at 1947–49. The Court did not decide the question because "[t]he parties do not identify a specific order in this case directing any proceeds to the Treasury. If one is entered on remand, the lower courts may evaluate in the first instance whether that order would indeed be for the benefit of investors as required by § 78u(d)(5) and consistent with equitable principles." *Id.* at 1949.

173. The William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021 ("2021 NDAA"), Pub. L. No. 116-283, § 6501, 134 Stat. 3388, 4625–26 (2021) (amending 15 U.S.C. § 78u).

174. SEC v. Hallam, 42 F.4th 316, 334–35 & n.69 (5th Cir. 2022) (quoting 2021 NDAA § 6501(a)(1)(B)(ii) & 15 U.S.C. § 78u(d)(3)(A)(ii) (some alterations removed); 2021 NDAA § 6501(a)(3) & 15 U.S.C. § 78u(d)(7); 2021 NDAA § 6501(a)(3) & 15 U.S.C. § 78u(d)(8)(A); 2021 NDAA § 6501(a)(3) & 15 U.S.C. § 78u(d)(8)(B)); 2021 NDAA § 6501(b) (designated for codification as a statutory note).

175. *Hallam*, 42 F.4th at 341, 344.

176. *Id.*

has survived the 2021 Exchange Act amendments" or whether legal disgorgement implicates the Seventh Amendment right to a jury trial.[177]

They did hold, however, that proof of the amount owed by legal disgorgement is subject to the shifting burden of proof set out above[178] and that legal disgorgement may be had without the SEC tracing the particular funds to be disgorged back to the money obtained from the securities violations.[179] Such an award is not subject, they reasoned, to the *Liu* constraint that it include only "net profits,"[180] but "an award including income that a defendant earned on his unjust enrichment is not permissible as legal disgorgement,"[181] although interest on the unjust receipts is allowed.[182]

In the case before the Fifth Circuit, the defendant had entered into an agreement with the Commission by which he did not contest liability but "agreed to certain remedies at a high level of generality," including "'disgorgement of ill-gotten gains.'"[183] The district court ordered the defendant to disgorge $1,901,480 and pay $424,375.38 in prejudgment interest.[184] Affirming,[185] the Fifth Circuit majority held that "the award was permissible as legal disgorgement" and hence did "not consider whether it met the standards for equitable disgorgement . . . under *Liu*."[186] Following the analysis set out above, the court of appeals rejected the defendant's argument that the order should be reversed because the SEC had not traced the proceeds to be disgorged back to the securities law violations, this argument having been "foreclosed" by Congress through the 2021 amendments.[187] As to his argument "that the energy companies he helped run weren't completely fraudulent," the majority responded that this did not "change the fact that *all* of the *securities* transactions during the relevant period were unlawful" because they were sold by "'misleading offering materials'" and that the district court's "calculation of [the defendant's] unjust enrichment was 'the compensation Hallam received for his role *in the sale of these securities*.'"[188] While, in order to be disgorged, "the payments must have been connected to the companies for which [he] sold securities," the defendant

177. *Id.* at 343–44. But the language of this analysis suggests that equitable disgorgement lives on under 15 U.S.C. § 78u(d)(5), with legal disgorgement added by § 78u(d)(3)(A)(ii) and (d)(7).

178. *Hallam*, 42 F.4th at 341.

179. *Id.* at 344 ("Congress has foreclosed [the defendant's] position on the availability of disgorgement without tracing.").

180. *Id.* at 343.

181. *Id.* The majority commented that "some equitable profit-based remedies, such as a constructive trust, allow that sort of recovery. So if we are confronted with an appeal from a request for an award of that nature, we may need to decide whether it could be equitable disgorgement consistent with *Liu*'s constraining those awards to 'net profits.'" *Id.* (quoting Liu v. SEC, 140 S. Ct. 1936, 1947 (2020)).

182. *Id.* at 341.

183. *Id.* at 319.

184. *Id.* at 320.

185. *Id.* at 319, 344.

186. *Id.* at 343.

187. *Id.* at 344.

188. *Id.* at 342–43 (emphasis by the court).

"provided little detail and no proof for [the] assertion" that they were not,[189] which was his burden because "[t]he district court concluded that the SEC had met its burden reasonably to approximate Hallam's net profits from the securities violations at $1,901,480."[190]

Significance and analysis. The Fifth Circuit's analysis suggests that (i) the Supreme Court found that SEC enforcement actions had been slipping the bounds imposed by equity in the disgorgement orders the Commission had been requesting; (ii) *Kokesh* and *Liu*, together, meant to correct this departure; (iii) Congress responded by amending the Exchange Act in 2021 to create a kind of disgorgement that (a) would not be limited by equitable boundaries but (b) would have other characteristics of previous federal disgorgement practice,[191] such as the burden-shifting protocol governing proof of amount.[192] Whether the Supreme Court will agree with this interpretation is an open question.[193]

3. SEC Enforcement Actions—Substance

The Ninth Circuit affirmed summary judgment against three defendants on the ground that they operated as unregistered brokers, resting its analysis on the short statutory definition of "broker" instead of a commonly employed multifactor test.[194] The Tenth Circuit affirmed summary judgment granted to the Commission on Rule 10b-5 violations based on a CEO's false statements concerning discussions with Apple, Inc. about Apple possibly using technology that the CEO's company had developed.[195]

Definition of "broker." Exchange Act section 15(a) makes it "unlawful for any broker . . . to effect any transactions in . . . any security . . . unless such broker . . . is registered" with the SEC.[196] Section 3(a)(4)(A) defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."[197]

189. *Id.* at 343.

190. *Id.* at 341. The concurring judge declined to join in the elaborate discussion of disgorgement history in federal securities cases. *Id.* at 344–45 (Oldham, J., concurring). As he saw it: "The real question is whether *Liu* or the statutory amendment somehow prevented Hallam from consenting to more than what the applicable statutes arguably permitted. As to that question, Hallam makes no argument, and I see nothing in *Liu* or the statutory amendment to suggest that Hallam can't consent to the disgorgement awarded by the district court." *Id.*

191. *Hallam*, 42 F.4th at 339 ("Congress used the term 'disgorgement' to authorize the sorts of disgorgement awards courts were ordering before *Liu*.").

192. *Id.* at 341.

193. Two other 2022 opinions addressing SEC remedies deserve mention. The Fourth Circuit found no error in a disgorgement order under 15 U.S.C. § 78u(d)(5) that imposed joint and several liability on an LLC and its chief executive manager. SEC v. Johnson, 43 F.4th 382, 389–93 (4th Cir. 2022). The Seventh Circuit found an "obey the law" injunction to constitute, under the circumstances, an abuse of discretion. SEC v. Goulding, 40 F.4th 558, 562–63 (7th Cir. 2022), *rehearing denied*, No. 20-1689, 2022 WL 4100421 (7th Cir. 2022), *cert. denied*, No. 22-687, 2023 WL 3800987 (June 5, 2023).

194. *See infra* notes 196–216 and accompanying text.

195. *See infra* notes 217–55 and accompanying text.

196. 15 U.S.C. § 78o(a)(1) (2018).

197. *Id.* § 78c(a)(4)(A).

The SEC brought an enforcement action against Sean Murphy, Jocelyn Murphy, and Richard Gounaud, alleging that they violated section 15(a) by failing to register as brokers while engaging in municipal bond trading for the account of a client, Ralph Riccardi.[198] Riccardi provided capital for the trades by linking his prime brokerage account to accounts in the individual names of the three defendants.[199] While the defendants and Riccardi testified that the defendants "had complete discretion to trade as they pleased and were 'never obligated to buy' the bonds requested by Riccardi," the "record brim[med] with examples of Riccardi directing [the defendants] to buy certain bonds and [defendants] complying," and the defendants "provided no evidence that they ever declined to purchase a bond requested by Riccardi."[200] When the defendants bought and sold bonds with funds that Riccardi provided, they shared both profits and losses with him.[201]

Affirming the district court's summary judgment for the Commission,[202] the Ninth Circuit interpreted the statutory definition by holding that "when someone places another's capital at risk by trading securities as his or her agent, he or she is trading securities 'for the account of others,' and is a 'broker' subject to § 15(a)'s registration requirements."[203] The defendants fit within this definition. They "made trades for 'the account of [Riccardi]' because they put Riccardi's capital at risk on every trade they made" and "[i]f the trade was unprofitable, Riccardi would bear a portion of the loss."[204] And they "traded 'for' Riccardi because they acted as his 'agents,'" under his control because "when Riccardi directed Appellants to place a trade, they complied."[205]

Significance and analysis. The district court had concluded that the defendants were brokers by applying a multifactor test enunciated by *SEC v. Hansen*.[206] Two members of the Ninth Circuit panel filed a concurrence in which they generally excoriated such tests as providing too little ex-ante guidance to the relevant regulated population and too much ex-post discretion to district courts.[207] They cautioned that "[w]e should avert our gaze from the temptations of a non-exclusive multifactor test when, as here, the statute provides enough guidance."[208]

198. SEC v. Murphy, 50 F.4th 832, 838 (9th Cir. 2022).

199. *Id.* at 839. As the court described it, the individuals' names "were registered to [Riccardi's company, RMR Asset Management ('RMR')]. When [the defendants] bought and sold securities in their individual accounts, the transaction was reported to the prime brokerage's clearing agent. RMR would then affirm the trade, and the funds would settle." *Id.*

200. *Id.* at 844.

201. *Id.* at 839 n.2 ("Typically, Appellants received between 50% and 60% of profits (or losses).").

202. *Id.* at 838, 840, 852.

203. *Id.* at 845.

204. *Id.* at 843.

205. *Id.* at 844. The panel rejected the defendants' contention that they were not Riccardi's agents but his "partners" in part because, even if that were so, "'[e]ach partner is an agent of the partnership for the purpose of its business.'" *Id.* (alteration by court) (quoting CAL. CORP. CODE § 16301(1)).

206. *Id.* at 840–41 (quoting SEC v. Feng, 935 F.3d 721, 732 (9th Cir. 2019) (applying SEC v. Hansen, No. 83 Civ. 3692, 1984 WL 2413, at *10 (S.D.N.Y. Apr. 6, 1984))).

207. *Id.* at 853–54 (Lee, J., concurring, joined by Fitzwater, J.).

208. *Id.* at 854.

Murphy includes one other holding of note. The district court imposed civil penalties.[209] The amounts of the penalties were based on the number of violations multiplied by statutory penalty amounts.[210] The Ninth Circuit acknowledged that "[t]he civil-penalty provision of the Exchange Act sets maximum penalties 'for each violation,' but does not define 'violation'" and observed that "[d]istrict courts have discretion to determine what constitutes a 'violation' and have relied on various proxies."[211] Here, the SEC requested that the number of tier-one violations used to compute penalties for Sean Murphy and Gounaud match the number of months during which each traded as unregistered brokers—respectively, sixty-five and forty-six—and the court used that method to calculate the penalty limits but discounted off those limits by 20 percent, bringing the amounts down to $414,090.40 against Sean Murphy and $308,512.80 against Gounaud.[212] The Ninth Circuit found no abuse of discretion in part because using the number of transactions conducted without registration would have resulted in "thousands of violations."[213] The district court imposed civil penalties on Jocelyn Murphy of $1,761,920,[214] concluding that she committed twenty-one tier-two "violations" because she provided false zip codes to underwriters in twenty-one conversations, even though she argued that "her § 10(b) liability turned on only three fraudulent transactions."[215]

Counting the number of Rule 10b-5 violations by the number of conversations in which a defendant made material false statements makes some sense, but so would using the number of times the defendant repeated the false statements in those conversations (which here would have increased the number of "violations") and so would the number of transactions that the false statements affected (which would have decreased the number). Computing the number of violations by the number of months a defendant operated as an unregistered broker, multiplying those months times the statutory penalty limit, then discounting by 20 percent, looks like backing into a number rather than a principled

In addition to the broker registration violations, the court of appeals affirmed summary judgment against Jocelyn Murphy for Rule 10b-5 violations consisting of providing false zip codes for her residence in order to gain allocation priority accorded by municipal issuers to retail investors in their localities. *Id.* at 838–40 (explaining the allocation system, its background, and its economic significance to issuers); *id.* at 841, 846–47 (addressing 10b-5 violation by providing false zip codes).

209. *Id.* at 841–42.

210. The court imposed tier-one penalties on Sean Murphy and Richard Gounaud and tier-two penalties on Jocelyn Murphy. *Id.* at 841; *see* 15 U.S.C. § 78u(d)(3)(B)(i), (ii) (2018). In each case, the per violation amount was limited to the greater of gross pecuniary gain, on the one hand, or, on the other hand, a statutorily fixed amount per violation, *id.*, which the SEC periodically adjusts, *see* U.S. Sec. & Exch. Comm'n, Adjustments to Civil Monetary Penalty Amounts, 88 Fed. Reg. 1614 (Jan. 11, 2023).

211. *Murphy*, 50 F.4th at 848.

212. *Id.* at 841–42.

213. *Id.* at 848 (responding to Gounaud's argument).

214. *Id.* at 842.

215. *Id.* at 848; *see supra* note 208.

decision. Leaving all of this to the discretion of the district court smacks of rule by black-robed men and women rather than by law.[216]

Liability for exaggerated representations of counterparty interest in technology purchase. The Commission pursued GenAudio, Inc. ("GenAudio") and its CEO, Jerry Mahabub, in a federal court enforcement action, winning summary judgment against them for violations of (i) Rule 10b-5 by six statements that Mahabub made, (ii) Securities Act section 17(a)(2) by one of those statements, and (iii) Securities Act section 5 by two offerings (one in 2010 and the other in 2011).[217] GenAudio produced software designed to change the perceived audio source from one location to a different location—to create the effect, for example, that the sound was coming from behind the listener even though the listener was facing the speaker.[218] The violations grew out of an effort by GenAudio to convince Apple, Inc. to incorporate the GenAudio software into Apple products.[219]

The district court ordered that GenAudio disgorge its proceeds from the two offerings (totaling $4,503,000) and pay a civil penalty in an equal amount.[220] The judgment ordered Mahabub to disgorge $1,280,900 from his personal sales of GenAudio shares and pay a civil penalty of the same amount.[221] The lower court also enjoined both defendants from further violations of the securities laws and barred Mahabub from serving as an officer or director of a public company.[222]

Affirming,[223] the Tenth Circuit reviewed summary judgment on each of the six statements.[224] In a March 10, 2010 email to GenAudio shareholders, Mahabub wrote that "GenAudio was 'starting to discuss the business side with the LCEC,'"[225] which both the defendants and the Commission understood to mean Large Consumer Electronics Company—in all relevant communications here, Apple, Inc. ("Apple").[226] While Mahabub contended that, on the basis of discussions between the two companies, he believed the statement he put into the email,[227] the Tenth Circuit held that "[t]he securities laws impose a personal

216. The Ninth Circuit rejected two other arguments of note against the penalties. First, it held that the district court "did not have to compare the Murphys' penalties to those imposed against other defendants" who had settled with consent decrees because the latter's penalties "resulted from bargained-for exchange" and those defendants "admitted wrongdoing while the Murphys continue[d] to dispute the wrongfulness of their conduct and have provided less-than-convincing assurances against future violations." *Murphy*, 50 F.4th at 849. Second, the Ninth Circuit held that the penalties imposed did not violate the Excessive Fines clause in the Eighth Amendment. *Id.* at 849–50.

In addition to the civil penalties, the district court entered injunctions against both the Murphys, rejecting their argument that the district court made "an impermissible credibility determination when it discredited [their] assurances against future violations." *Id.* at 851.

217. SEC v. GenAudio Inc., 32 F.4th 902, 910–11 (10th Cir. 2022).

218. *Id.* at 911.

219. *Id.* at 911–12.

220. *Id.* at 919.

221. *Id.*

222. *Id.*

223. *Id.* at 911, 956.

224. *Id.* at 921–34.

225. *Id.* at 922.

226. *Id.* at 914 n.2.

227. *Id.* at 922. Defendants argued that "Mr. Mahabub 'had raised negotiating points with Apple regarding a potential transaction[';] . . . Mr. Mahabub indicated in his correspondence with Apple

obligation on corporate executives . . . to sufficiently ground their communications in facts."[228] The appellate court's review convinced it that "[i]rrespective of the business overtures that Mr. Mahabub made to Apple's executives, they had made it crystal clear that no business negotiations would take place between GenAudio and Apple until *after* there was 'exec buy-in,' and the record provides no basis for a reasonable belief that such buy-in had occurred when Mr. Mahabub sent the email on March 10."[229] This sequence supported not only the district court finding that Mahabub's email was false[230] but also that he sent the email with at least the recklessness that suffices for Rule 10b-5 scienter.[231]

In the same March 10, 2010 email to GenAudio shareholders, Mahabub said "that he 'expect[ed] to have a very substantial license deal in place for [the LCEC's] Christmas Product Rollout.'"[232] But the Tenth Circuit found "that GenAudio's discussions with Apple had not reached the point—by the time Mr. Mahabub sent the March 10 email . . . —where Mr. Mahabub could have harbored any reasonable belief that any licensing deal was even on the table for discussion with Apple."[233] As to falsity, "any fanciful belief that may have led Mr. Mahabub to send the email regarding the purported Christmas product rollout did not 'fairly align[ ] with the information' in his 'possession at the time,' and his words—whether expressing an opinion or not—provide the foundation for liability under the securities laws."[234] As to scienter, "[t]he 'Christmas product rollout' statement at issue here was false—indeed, fabricated. And, at a minimum, Mr. Mahabub—the acknowledged fabricator of the statement—acted with recklessness in communicating it."[235]

The third liability-generating statement appeared in a cover letter sent with the 2010 offering documents, and represented that that offering "was 'being conducted to provide bridge capital until we can "ink" a deal with . . . [the

employees that 'he still understood a deal would be reached in the next 3–6 months, and . . . [his] Apple contacts never told [Mr.] Mahabub his belief was unrealistic.'" *Id.* (quoting Appellants' Opening Brief).

228. *Id.* at 924 (citing Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175, 188–89 (2015)).

229. *Id.* (emphasis by the court). Mr. Hailey, a product manager for the iPod, had emailed Mahabub on December 16, 2009, using the very phrase that Mahabub used in his March 2010 email to shareholders, with Hailey saying "the deal was 'not something we can execute overnight.' Critically, Mr. Hailey explained that '[t]he business side of things would come into play *after* we have exec buy-in on the product side.' And in a subsequent email sent on January 5, 2010, Mr. Hailey further noted that although Apple was 'pretty serious about looking at audio quality across the board,' the partnership 'will take time—definitely more than a couple of months.'" *Id.* at 913 (some emphasis by court omitted) (record citations to emails omitted).

230. *Id.* at 924, with the Tenth Circuit adding: "no matter how Panglossian their view of the world, corporate executives, like Mr. Mahabub, cannot make material representations to their shareholders in blatant disregard of obvious facts and be excused by the failures of others to correct their false notions."

231. *Id.* at 923.

232. *Id.* at 924 (alteration in original).

233. *Id.* at 925.

234. *Id.* (quoting Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175, 189 (2015)).

235. *Id.* at 926.

LCEC].'"[236] Here the Tenth Circuit focused on use of the term "bridge capital," reasoning that it "was intended to (falsely) communicate that a deal between GenAudio and Apple was imminent and that the 2010 Offering was needed to provide GenAudio with capital during the reasonably short period necessary to close the deal with Apple."[237] The disjunction between the reality of the GenAudio/Apple discussions and the normal meaning of "bridge capital" (temporary capital needed to bridge the liquidity gap before permanent capital arrives) led to the conclusion that Mahabub's use of the term constituted a false statement made recklessly in a 10b-5 sense.[238]

An April 30, 2010 email from Mahabub to an investor included the fourth statement found fraudulent—"that Apple was 'looking to acquire GenAudio's tech for integration into their entire lineup of product offerings . . . and we are now waiting [for the time] when we will initiate negotiations, pending the CEO['s] [approval of] the integrated product rollout strategy and the technical implementation strategy that will be presented to the CEO next week!!!'"[239] In fact, Mahabub by the date of this email "had received absolutely no confirmation from his Apple contacts . . . that in the near future (much less the following week) there would be a presentation to Apple's CEO of an integrated product-rollout strategy regarding GenAudio's technology and also regarding a related technical-implementation strategy."[240] To the contrary, he had been told that any business discussions would await "'exec buy-in on the product side.'"[241] And, in fact, the meeting in the week following the email would "address first principles, such as whether the 'idea' or 'concept' that GenAudio's technology illustrated was a 'great' one."[242] Accordingly, the Tenth Circuit agreed with the district court that "Mr. Mahabub 'could not have reasonably failed to perceive that he was simply making things up as he wrote' the April 30 email. Notwithstanding any contrary subjective beliefs that Mr. Mahabub may have harbored, we conclude that he acted at least recklessly (if not knowingly)."[243]

236. *Id.* (some alteration changed).

237. *Id.* (quoted language).

238. *Id.* at 928; *see also id.* at 927–28 ("The statement's use of the term 'bridge capital' is significant. As [defendants] themselves define it, the term 'bridge capital' 'is a commonly used corporate term that describes temporary funding a company needs to cover its operating expenses *until* some permanent source of funding can be secured in the future.' . . . [T]his seems to necessarily connote that there is a realistic expectation that permanent funding will be secured in the reasonably near future—not, as [defendants] suggest, at some hoped-for, nebulous 'unknown time in the future.'" (record citation omitted)).

239. *Id.* at 930.

240. *Id.* at 931.

241. *Id.* (quoting the Hailey email described in *supra* note 229).

242. *Id.* at 932. While this explanation comes from an email to Mahabub on May 5—after he sent his April 30 email—"there is no indication in the record that Mr. Tiscareno [an Apple engineer who authored the May 5 email] or GenAudio's other contacts at Apple had ever previously told Mr. Mahabub anything to the contrary." *Id.*

The statement in the April 30 email to the investor is the only one as to which the district court granted summary judgment to the Commission on its Securities Act section 17(a)(2) claim as well as on its Rule 10b-5 claim. *Id.*

243. *Id.* (quoting SEC v. Mahabub, 343 F. Supp. 3d 1022, 1046 (D. Colo. 2018)).

The fifth false statement came from an August 1, 2010 Mahabub letter "claiming that Mr. Jobs had requested 'a "hand-shake" meeting' with Mr. Mahabub '[i]n the very near future.'"[244] While the defendants argued that this representation was not material in light of the "exec buy-in" meeting at which the defendants said Mahabub anticipated that Jobs would green-light a deal, the court of appeals panel found itself "hard pressed to understand why it would not have been material to a reasonable investor that the CEO of the company that GenAudio was negotiating with regarding the use of its technology affirmatively requested a hand-shake meeting in 'the very near future' with GenAudio's CEO, Mr. Mahabub."[245] In any event, Mahabub had been advised by this time that the internal Apple meeting in early May had been devoted only to discussing whether Apple's use of the GenAudio technology made sense as a concept.[246] As to the specific statement that Jobs had, in fact, asked for a "hand-shake" meeting with Mahabub, the district court had found this to be a "blatant lie," and the Tenth Circuit concluded that "at the very least, Mr. Mahabub made the statement in reckless disregard of the relevant facts."[247]

The sixth and last statement appeared in "Mahabub's March 29, 2011, email to shareholders that certain new agreements would completely prohibit him from mentioning the LCEC in future correspondence, including in the upcoming 2011 Offering."[248] The panel agreed with the district court that "Mahabub well knew (or at least recklessly disregarded), the natural effect of the email was to 'tease[] shareholders' about forward progress in GenAudio's business negotiations with Apple—which a reasonable investor would have deemed to be material information."[249] In fact, Mahabub "knew that the evaluation agreements he needed to sign [the 'certain new agreements' to which his email referred] pertained to the broken-down iMacs he himself requested from Apple,"[250] "specifically, an iMac 'with a bad screen or some form of prototype that has bad parts in it'—to create a demonstration of AstoundSound."[251]

Turning from the fraud counts to the claim that Mahabub and GenAudio had violated the Securities Act section 5 requirement that every stock sale be either registered or qualify for at least one exemption from registration, the Tenth Circuit leaned on the rule that a defendant contesting a registration violation has the burden of proving that the sale satisfied an exemption rather than the Commission having to prove that possible exemptions did not apply.[252] As to the Securities Act section 4(a)(2) exemption for nonpublic offerings, the defendants did "'not describe any evidence [they] may introduce to persuade a jury that the

244. *Id*. at 932–33 (quoting Aplts. App'x, Vol. V, at 1313).
245. *Id*. at 933.
246. *Id*. at 934.
247. *Id*. (quoting *Mahabub*, 343 F. Supp. 3d at 1044).
248. *Id*.
249. *Id*. at 935 (alteration in original) (quoting *Mahabub*, 343 F. Supp. 3d at 1044).
250. *Id*.
251. *Id*. at 916.
252. *Id*. at 940–41, 943.

relevant factors favor application of the exemption in [their] favor.'"[253] As to the Rule 506 exemption, the defendants could not prove that either the 2010 or 2011 offering had solicited no nonaccredited investors, which was integral to the exemption because it required that all nonaccredited purchasers must have been provided structured disclosure including audited financial statements, and GenAudio had provided no such audited statements.[254]

Significance and analysis. *GenAudio* seems rightly decided, given its facts. But it highlights a real problem. Executives selling the technology or other asset of their own company to a counterparty may be unfamiliar with the counterparty's internal processes. As a result, the selling company's executives may misinterpret the significance of steps that the counterparty takes and pass that misinterpretation on to shareholders or the market. This may be a particular problem in the case where a small seller is selling to a large and bureaucratized buyer. Counselors to the seller should advise caution, conservative interpretations, and abundant warnings to all outsiders with whom the seller is communicating, with those warnings emphasizing that interim steps do not cement or guarantee any deal and, if appropriate, that the potential buyer's internal considerations are opaque to the seller.

On the risk side, there was more to *GenAudio* than the six statements on which the district court awarded summary judgment. Most notably, Mahabub had altered emails from Apple before forwarding them on to others in ways that made a deal between GenAudio and Apple seem more probable.[255] Those alterations may well have influenced the SEC's decision to pursue an enforcement action. In short, and obviously, the risk of an enforcement action based on a misinterpretation of a counterparty's interest increases with egregious conduct such as altering documents.

4. Effect on Federal Jurisdiction of Bylaw Choice of Forum Provision

Boeing Company ("Boeing"), a Delaware corporation, included in its bylaws a provision stating that "'unless the Corporation consents in writing to the

253. *Id.* at 942 (quoting *Mahabub*, 343 F. Supp. 3d at 1041). More specifically, the SEC argued that GenAudio "cannot identify to whom it offered the stock, its relationship with the offerees, the nature, scope, size, type and manner of the offering." *Id.* at 941.

254. *Id.* at 942–43. At one point, the court of appeals intimates that a Rule 506 exemption requires that structured information be provided to all nonaccredited *solicitees*. *Id.* at 943. In fact, the exemption requires such disclosure only to nonaccredited *purchasers*. See 17 C.F.R. § 230.506(b)(1), requiring compliance with Rule 502 and 17 C.F.R. § 230.502(b)(1) (version of CFR in effect on May 1, 2012, GenAudio's 2011 offering concluding at the end of April 2012). *GenAudio*, 32 F.4th at 917.

To be an accredited investor, the investor must either (i) meet one of the alternative definitions for accreditation or (ii) the issuer must "reasonably believe[]" that the investor meets one of the alternative definitions. 17 C.F.R. § 230.501(a) (version of CFR in effect on May 1, 2012). GenAudio could not prove either because "GenAudio's main fundraiser . . . 'admittedly overlooked at least some' incomplete questionnaires that GenAudio had provided to its investors to solicit information relevant to the accreditation question." *GenAudio*, 32 F.4th at 943 (record citation omitted) (quoting fundraiser's deposition).

In addition to ruling on the substance of the Commission's liability claims, the Tenth Circuit also rejected challenges to the disgorgement and civil penalties the lower court ordered. *Id.* at 944–52, 954–55.

255. *GenAudio*, 32 F.4th at 912.

selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for . . . any derivative action or proceeding brought on behalf of the Corporation.'"[256] As part of a slew of lawsuits and investigations following two fatal crashes of Boeing's 737 MAX airliner, a shareholder brought in federal court a derivative claim under Exchange Act section 14(a) alleging false statements in proxy materials in 2017–19 concerning the development and operation of that aircraft.[257] Reversing dismissal by the district court after it granted a forum non conveniens motion resting on this bylaw,[258] the Seventh Circuit reviewed the lower court ruling de novo because "the district court based its decision on its view of legal issues."[259] "[D]efendants conceded that enforcement of the forum bylaw [here] would foreclose the [plaintiff's] federal derivative suit entirely."[260]

Delaware General Corporation Law section 115 provided "that 'bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State.'"[261] A majority of the panel reasoned that the federal court in Delaware was one of "the courts in this State" within the meaning of section 115.[262] Moreover, the synopsis covering section 115 when it was adopted stated that it "was 'not intended to authorize a provision that purports to foreclose suit in a federal court based on federal jurisdiction.'"[263] Accordingly, "[a]s applied here, Boeing's forum bylaw violates Section 115 because it is inconsistent with the jurisdictional requirements of the Exchange Act of 1934, 15 U.S.C. § 78cc(a)," giving exclusive jurisdiction to federal courts over claims brought under that act.[264]

5. Definition of Statutory Seller for Securities Act Section 12 Liability in the Internet Age

Section 12(a)(1) imposes liability on those who "offer or sell a security" without either registering the sale under the Securities Act or qualifying for an exemption from registration, and section 12(a)(2) imposes liability on those who "offer or sell a security" by a prospectus that contains material misstatements

256. Seafarers Pension Plan on behalf of Boeing Co. v. Bradway, 23 F.4th 714, 718 (7th Cir. 2022) (quoting bylaw).

257. *Id.* at 717.

258. *Id.* at 717–18, 728.

259. *Id.* at 719.

260. *Id.* at 718. The Exchange Act gives federal courts exclusive jurisdiction over lawsuits brought under its provisions. *Id.* at 719 (citing 15 U.S.C. § 78aa).

261. *Id.* at 720 (quoting 8 Del. C. § 115).

262. *Id.*

263. *Id.* at 720 & n.2 (adding in the note that "Delaware law holds that a bill synopsis is a proper source from which to glean legislative intent where the statutory language seems ambiguous").

264. *Id.* at 720. The dissenter argued that, since the plaintiff retained its right to bring a *direct* action in federal court based on Exchange Act section 14(a), as opposed to a derivative action, "it is hard to see how it has been deprived of a right to enforce § 14(a)." *Id.* at 729 (Easterbrook, J., dissenting). As to section 115, he pointed out that it permitted Boeing "to choose among 'any' of the courts 'in' Delaware," and Boeing had simply chosen the Court of Chancery. *Id.* at 732.

or omissions—with the liability running in each case "to the person purchasing such security from him."[265] In *Pinter v. Dahl*, the Supreme Court defined two categories of "sellers" who are proper defendants under section 12: (i) "the owner who passed title, or other interest in the security, to the buyer for value";[266] and (ii) those "who successfully solicit[ed] the purchase, motivated at least in part by a desire to serve [their] own financial interests or those of the securities owner."[267] In 2022, both the Eleventh Circuit[268] and the Ninth Circuit held that those who promote securities on the internet can fall into the second category—soliciting sellers.[269]

In the Eleventh Circuit case—*Wildes v. BitConnect International PLC*—the plaintiffs bought a cryptocurrency from BitConnect.[270] It turned out that BitConnect was conducting a Ponzi scheme, with early investors receiving returns from money paid by later investors.[271]

The cryptocurrency was sold through a multilevel marketing structure that offered investors the opportunity to become promoters, who could then offer the cryptocurrency to investors that they attracted—with some share of a new investment going to the promoter bringing in the new investor, another share to that promoter's promoter, and so on.[272]

Glenn Arcaro served as the "national promoter for the United States," heading up "a team of regional promoters," who "created an extensive U.S. marketing scheme" that "included multiple websites where Arcaro encouraged viewers to buy BitConnect coins."[273] When the scheme fell apart, investors filed a multi-count complaint against Arcaro and five regional promoters, including a Securities Act section 12(a)(1) claim for selling unregistered securities.[274] Reversing

265. 15 U.S.C. § 77*l*(a) (2018).

266. 486 U.S. 622, 642 (1988).

267. *Id.* at 647. The *Pinter* plaintiff sued under what is now subsection 12(a)(1), but courts have extended *Pinter*'s definition of statutory seller to subsection 12(a)(2) as well. *See* J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT & LITIGATION UNDER THE 1933 ACT § 5:35 (2022) ("[T]he analysis under *Pinter* is the same for purposes of both Section 12(a)(1) and 12(a)(2) claims.").

268. *See infra* notes 270–84 and accompanying text.

269. *See infra* notes 285–301 and accompanying text.

270. 25 F.4th 1341 (11th Cir. 2022), *cert. denied*, Arcaro v. Parks, 143 S. Ct. 427 (2022) (mem.).

271. *Id.* at 1343.

272. *Id.* at 1343–44.

273. *Id.* at 1344. More specifically,

> At glennarcaro.com . . . [Arcaro] told potential investors that passive income was merely "a click away"—all they needed to do was take "a few minutes" to join BitConnect. At BitFunnel, he instructed investors to fill out a form to access a video about "how to make huge profits with BitConnect." And at Futuremoney.io, Arcaro hosted a course called Cryptocurrency 101, which culminated in lessons on how to create a BitConnect account and how to transfer bitcoin there. Arcaro also shaped his team's recruitment efforts, directing regional promoters to create videos about investing that always ended with a pitch for BitConnect. Together, Arcaro and his team posted thousands of YouTube videos extolling BitConnect, and those videos were viewed millions of times.

Id. at 1344.

274. *Id.* at 1344 & n.2.

dismissal of that claim,[275] the Eleventh Circuit disagreed with the district court's conclusion that a soliciting seller must have "urged or persuaded" buyers "'individually' . . . to purchase BitConnect coins"; that is, by a "'personal solicitation' from the promoters."[276]

The court of appeals reasoned that (i) section 12(a)(1) imposes liability on a person who "offers or sells" a security in a transaction that is neither pursuant to an effective registration statement nor qualifies for an exemption from registration; and (ii) the statutory definition of "offer" includes "solicitation of an offer to buy."[277] The statutory definitions do not "limit solicitations to 'personal' or 'individualized' ones," and the "Securities Act precedents do not restrict solicitations under the Act to targeted ones."[278] All that is needed is that the defendant "'urge or persuade' another to buy a particular security," that the solicitation "succeed," and that it "be motivated by a desire to serve the solicitor's or the security owner's financial interests."[279] The circumstance that technology permits mass solicitation via "podcasts, social media posts, or, as here, online videos and web links" makes no difference, "especially [since] the Act covers 'any means' of 'communication.'"[280]

Significance and analysis. *BitConnect* does not elaborate how the individual defendants received money from the cryptocurrency sales to individual plaintiffs, though that may not have been at issue given the multilevel marketing structure that BitConnect employed. More troubling, however, is that the Eleventh Circuit focuses only on the words "offers or sells." Section 12 goes on to state that liability runs only from the seller to "the person purchasing such security *from him*."[281] As the Supreme Court put it in *Pinter*, the "clause of § 12[(a)], which provides that only a defendant 'from' whom the plaintiff 'purchased' securities may be liable, narrows the field of potential sellers" from all of those who might be swept in by the broad statutory definitions of "sale" and "offer to sell."[282] Illustrating what it meant by a soliciting seller, the Court provided this example: "A natural reading of the statutory language would include in the statutory seller status at least some persons who urged the buyer to purchase. For example, a securities vendor's agent who solicited the purchase would commonly be said, and would be thought by the buyer, to be among those 'from' whom the buyer 'purchased' even though the agent himself did not pass title."[283]

275. *Id.* at 1347. The district court dismissed one regional promoter because the plaintiffs did not timely serve him and dismissed three other regional promoters because the plaintiffs had failed to prosecute them. *Id.* at 1344 n.2, 1346 n.5. The Eleventh Circuit affirmed all these dismissals. *Id.* at 1347.

276. *Id.* at 1344–45 (quoting *In re* BitConnect Sec. Litig., CASE No. 18-cv-80086-MIDDLEBROOKS, 2019 WL 9171208, at *3, *5–6 (S.D. Fla. Nov. 15, 2019)).

277. *Id.* at 1345 (quoting 15 U.S.C. §§ 77b(a)(3), 77*l*(a)(1)).

278. *Id.* at 1345–46.

279. *Id.* at 1346 (quoting, first, Ryder Int'l Corp. v. First Am. Nat'l Bank, 943 F.2d 1521, 1531, 1534 (11th Cir. 1991); then quoting Pinter v. Dahl, 486 U.S. 622, 647 (1988)).

280. *Id.* (quoting 15 U.S.C. § 77e(a)(1)).

281. 15 U.S.C. § 77*l*(a) (2018) (emphasis added).

282. *Pinter*, 486 U.S. at 643.

283. *Id.* at 644.

The potential problem with disconnecting the solicitor from the purchaser through liability imposed simply on the basis that a defendant put a video pitch on the web that someone who later bought a security watched by clicking on a link is that it is unclear whether—even in our technologically advanced world—it "would commonly be said, and would be thought by the buyer" that the producer of the video or the speaker in it was "among those 'from' whom the buyer 'purchased.'"[284]

The Ninth Circuit followed the Eleventh in *Pino v. Cardone Capital, LLC*.[285] Grant Cardone served as the CEO and sole manager of Cardone Capital, LLC, which managed Cardone Equity Fund V, LLC ("Fund V") and Cardone Equity Fund VI, LLC ("Fund VI")—both of which invested in real estate.[286] Pino allegedly "invested a total of $10,000 in Funds V and VI."[287] Pino sued, purportedly on behalf of a class of all who purchased interests in the funds.[288]

The operative complaint alleged as follows: Pino "attended the 'Breakthrough Wealth Summit' in Anaheim, California, hosted by Grant Cardone" on September 21, 2019.[289] On September 23, Pino "invested in Fund V."[290] On September 26, 2019, "Cardone posted on the Cardone Capital Instagram account that Fund V is 'the first Regulation A of its kind to raise $50 Million in crowdfunding using social media' and that '[b]y accessing social media, I am offering investment opportunities to the everyday investor, like you!'"[291] In a September 28 Instagram post, Cardone stated that funding for Fund V had closed and claimed that "[b]y using no middleman & going directly to the public using social media we reduce our cost. This ensures more of your money goes directly into the assets, resulting in lower promotional cost."[292]

Pino's complaint alleged that Cardone and Cardone Capital violated Securities Act section 12(a)(2) by making "untrue statements of material fact or concealed or failed to disclose material facts in Instagram posts and a YouTube video posted between February 5, 2019, and December 24, 2019."[293] For example, Cardone allegedly stated in an April 22, 2019 YouTube video: "'it doesn't matter whether [the investor] [is] accredited [or] non-accredited . . . you're gonna walk away with a 15% annualized return. If I'm in that deal for 10 years, you're gonna earn 150%. You can tell the SEC that's what I said it would be. They call me Uncle G and some people call me Nostradamus, because I'm predicting the

284. *Id.*

285. 55 F.4th 1253, 1260 (9th Cir. 2022), *docketing petition for cert.*, No. 22-1016 (Apr. 19, 2023).

286. *Id.* at 1255.

287. *Id.* at 1256.

288. First Amended Compl. at para. 2, Pino v. Cardone Cap., LLC, No. 2:20-cv-08499-JFW-KS, 2021 WL 9526341 (C.D. Cal. Feb. 19, 2021) [hereinafter Pino FAC].

289. *Id.* at para. 35.

290. *Id.* at para. 36.

291. *Pino*, 55 F.4th at 1256. The court of appeals does not provide the date of this posting, but the complaint does. Pino FAC, *supra* note 288, at para. 38.

292. Pino FAC, *supra* note 288, at paras. 39, 40.

293. *Pino*, 55 F.4th at 1256.

future, dude; this is what's gonna happen.'"[294] And, in Instragram posts, Cardone advertised high rates of returns—e.g., a February 5, 2019 post asked rhetorically "'[w]ant to double your money[?]' and state[d] that an investor could receive $480,000 in cash flow after investing $1,000,000, achieve 'north of 15% returns after fees' and obtain '118% return amounting to 19.6% per year.'"[295] Pino alleged that "none of the communications contained cautionary language either indicating that the promises were speculative, or identifying the risk associated with investing in Funds V and V[I] [sic]."[296]

After the district court dismissed on the ground that the defendants had not "solicited" Pino's purchase within the meaning of section 12 and the *Pinter* decision, the Ninth Circuit reversed insofar as the dismissal was based on that reasoning.[297] There was "no question that Cardone and Cardone Capital had financial interests tied to the Funds. Cardone Capital received 35% of the Funds' profits . . . ."[298] There was accordingly no question that the social media communications set out above were motivated at least in part by the defendants' own financial interests.[299]

The key question was thus whether the social media communications constituted "solicitation" even though they were widely broadcast instead of personally directed to Pino or other purchasers in Funds V and VI. Leaning on the Eleventh Circuit's reasoning in *BitConnect*, the Ninth Circuit concluded that "nothing in § 12 expressly requires that solicitation must be direct or personal to a particular purchaser to trigger liability under the statute. Put differently, nothing in the Act indicates that mass communications, directed to multiple potential purchasers at once, fall outside the Act's protections."[300] And, from a policy viewpoint, including promoters' social media posts within section 12(a)(2)'s liability net made sense because "the advertisements at issue in this case—Instagram posts and YouTube videos—are the types of potentially injurious solicitations that are

294. *Id.* (alteration in original) (citing Pino FAC, *supra* note 288, at paras. 1, 56).

295. *Id.* (quoting Pino FAC, *supra* note 288, at para. 67).

296. *Id.*

297. *Id.* at 1255, 1260–61. In a separate memorandum decision, the Ninth Circuit held that only some of the alleged misstatements were actionable, and therefore the court affirmed the dismissal in part and reversed it in part. *Id.*; *see* Pino v. Cardone Cap., LLC, No. 21-55564, 2022 WL 17834235, at *1, *4 (9th Cir. Dec. 21, 2022), *amended & superseded denial of rehearing*, 2023 WL 2158802 (9th Cir. Feb. 22, 2023).

298. *Pino*, 55 F.4th at 1258 (record citation omitted).

299. *Id.* As to another element, the communications were "prospectuses" for purposes of section 12(a)(2) liability, since the Securities Act defines "prospectus" to include any "written" "communication" "which offers any security for sale," 15 U.S.C. § 77b(a)(10) (2018); "offer to sell" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security," *id.* § 77b(a)(3); and a "written" communication to include a "graphic communication," *id.* § 77b(a)(3). SEC Rule 405 then expressly defines "graphic communication" to include "all forms of electronic media." 17 C.F.R. § 230.405 (2022). See *Pino*, 55 F.4th at 1258–59, making some, but not all, of these connections.

300. *Pino*, 55 F.4th at 1258 (citing Wildes v. BitConnect Int'l PLC, 25 F.4th 1341, 1345–46 (11th Cir. 2022)); *id.* at 1260 ("[W]e conclude that § 12 contains no requirement that a solicitation be directed or targeted to a particular plaintiff, and accordingly, join the Eleventh Circuit in holding that a person can solicit a purchase, within the meaning of the Securities Act, by promoting the sale of a security in a mass communication.").

intended to command attention and persuade potential purchasers to invest in the Funds during the 'most critical' first stage of a selling transaction, when the buyer becomes involved."[301]

6. Purchaser/Seller Rule for Standing in Private Rule 10b-5 Actions

In *Blue Chip Stamps v. Manor Drug Stores*,[302] the Supreme Court adopted the Second Circuit's *Birnbaum v. Newport Steel Corp*. holding that a private lawsuit to recover for a violation of Rule 10b-5 can only be brought by a plaintiff who was defrauded by the violation into purchasing or selling the relevant security.[303] In *Menora Mivtachim Insurance Ltd. v. Frutarom Industries Ltd.*, the Second Circuit applied that rule in a case where the target company in a merger allegedly made false statements about itself that led the plaintiffs to buy stock in the acquiring company.[304]

Plaintiffs alleged that, from 2002 to 2018, Frutarom Industries ("Frutarom")—an Israeli firm selling flavors and fragrances—bribed key employees to obtain business, as well as customs and quality assurance officials in Russia and Ukraine to facilitate importation of Frutarom products into those countries and secure certifications for the products there.[305] After Frutarom agreed on May 7, 2018 to merge with Flavors & Fragrances Inc. ("IFF") but before consummation of the deal, the IFF S-4 Registration Statement for the deal—filed on June 19, 2018—included Frutarom's representation in the merger agreement "that since December 31, 2014, Frutarom had not 'violated the [Foreign Corrupt Practices Act], the U.K. Bribery Act 2010, the [Organisation for Economic Co-operation and Development] Convention on Combating Bribery of Foreign Public Officials in International Business Transactions or any other applicable Law relating to anti-corruption or anti-bribery.'"[306] Frutarom had also "attribut[ed] its financial growth in 2016 and 2017 to factors such as 'organic growth,' 'acquisitions,' and 'positive currency effects'" without mentioning the bribery scheme.[307]

301. *Id.* at 1260 (quoting Pinter v. Dahl, 486 U.S. 622, 646–47 (1988)).

302. 421 U.S. 723, 749 (1975).

303. 193 F.2d 461, 464 (2d Cir. 1952).

304. 54 F.4th 82, 84 (2d Cir. 2022).

305. *Id.*

306. *Id.* (alteration in original) (quoting complaint); *see also* Int'l Flavors & Fragrances Inc., Agreement and Plan of Merger by and among Icon NewCo Ltd. and Frutarom Ltd. (Form S-4) § 3.20(a), at A-33 (June 19, 2018) [hereinafter IFF-Frutarom S-4], https://www.sec.gov/Archives/edgar/data/51253/000119312518197017/d604634ds4.htm (attached as Annex A). IFF paid for the merger with a combination of cash and IFF stock. *Id.* at 8 (each share of Frutarom stock converted into $71.19 cash and 0.2490 share of IFF stock).

307. *Frutarom*, 54 F.4th at 84 (quoting complaint). The S-4 for the issuance of the IFF stock in the deal makes such statements about Frutarom. *See* IFF-Frutarom S-4, *supra* note 306, at 41, 51. Frutarom was responsible for these statements because the S-4 stated that "IFF has supplied all information contained or incorporated by reference into this prospectus relating to IFF and Icon Newco Ltd., and *Frutarom has supplied all such information relating to Frutarom*." *Id.* at ii (emphasis added).

The merger closed in October 2018.[308] IFF "acknowledged" on August 5, 2019, "that Frutarom had 'made improper payments to representatives of a number of customers' in Russia and Ukraine."[309] IFF's stock fell almost 16 percent.[310]

Plaintiffs sued Frutarom and some of its officers under Rule 10b-5, with the plaintiffs purporting to represent those who acquired IFF stock between May 7, 2018 and August 12, 2019.[311] Affirming dismissal,[312] the Second Circuit panel majority held that the *Blue Chip Stamps* rule "requires plaintiffs to have bought or sold the security *about which a misstatement was made* in order to have standing to sue under Section 10(b)."[313] Accordingly, plaintiffs "lack[ed] statutory standing to sue Frutarom based on alleged misstatements about Frutarom because they bought shares of IFF, not Frutarom."[314]

Significance and analysis. The third panel member concurred but would have decided the case on the narrower ground that the plaintiffs had failed to "demonstrate[] a sufficient relationship between Frutarom's alleged misstatements and IFF's stock price."[315] The majority reasoning seems preferable. Although the direct relationship language derives from a Second Circuit decision that interprets *Blue Chip Stamps* and therefore concerned standing,[316] a "direct relationship" test sounds awfully close to the "in connection with" element of a Rule 10b-5 violation.[317] The SEC must prove that element, but need not prove the additional standing element that a private plaintiff must satisfy.[318] Accordingly, deciding the case on the standing question still leaves open the possibility that the SEC could bring a lawsuit in a case analogous to this one.

308. *Frutarom*, 54 F.4th at 84.

309. *Id.* at 85.

310. *Id.*

311. *Id.* at 84. August 12 was the date on which the complaint was filed. Menora Mivtachim Ins. Ltd. v. Int'l Flavors & Fragrances Inc., 19 Civ. 7536 (NRB), 2021 WL 1199035, at *7 (S.D.N.Y. Mar. 30, 2021). The plaintiffs sued IFF and two of its officers and Frutarom and five of its officers. The district court dismissed the claims on a number of grounds, including that the plaintiffs had no standing to sue the Frutarom defendants. The plaintiffs "pursue[d] their appeal against only Frutarom and four of its officers." *Frutarom*, 54 F.4th at 85.

312. *Frutarom*, 54 F.4th at 84, 89.

313. *Id.* at 86 (emphasis added).

314. *Id.* at 85, 86.

315. *Id.* at 91 (Pérez, J., concurring). He derived this test from *Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27, 34 (2d Cir. 2004).

316. *See Nortel*, 369 F.3d at 30–34.

317. Rule 10b-5 prohibits certain actions "in connection with" the purchase or sale of securities. 17 C.F.R. § 240.10b-5 (2022).

318. SEC v. Goble, 682 F.3d 934, 944–45 (11th Cir. 2012) (reversing in part a judgment for the Commission entered after a bench trial because a sham transaction was not "in connection with" the purchase or sale of a security); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 751 n.14 (1975) ("Our decision in *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969), established that the purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for injunctive relief under [§] 10(b) and Rule 10b-5." (parallel citation omitted)).

7. Relationship Between the Three Subparts of Rule 10b-5

Rule 10b-5 contains three subparts.[319] Subpart (b) prohibits "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 . . . not misleading."[320] Subparts (a) and (c) do not include the word "statement" but respectively prohibit "employ [ing] any device, scheme, or artifice to defraud" and "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[321]

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Supreme Court held that liability under Rule 10b-5 in a private lawsuit is limited to primary violators of the rule and cannot encompass those who only aid and abet a violation.[322] In *Janus Capital Group, Inc. v. First Derivative Traders*, the Court held that primary liability under Rule 10b-5 subpart (b) can be imposed only on defendants who "make" the prohibited statements, and that the "maker" of any such statement "is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[323] In *Lorenzo v. SEC*, the Court "recognized considerable overlap among the subsections of the Rule,"[324] and held that a defendant who, with scienter, "disseminat[es]" a false or misleading statement violates Rule 10b-5(a) and (c), even if that defendant does not "make" the statement within the *Janus* definition of that word and even if "the only conduct involved concerns a misstatement."[325] On the other hand, the *Lorenzo* majority also "assume[d] that *Janus* would remain relevant (and preclude liability) where an individual neither makes nor disseminates false information—provided, of course, that the individual is not involved in some other form of fraud."[326] In 2022, the Second Circuit tried to reconcile these rulings in light of its own 2005 decision in *Lentell v. Merrill Lynch & Co.*, holding that "where the sole basis for such claims is alleged misrepresentations or omissions," a plaintiff cannot make out a case under Rule 10b-5(a) and (c).[327]

The 2022 opinion considered an enforcement action brought against the Rio Tinto company ("RT"), its CEO, and CFO.[328] The case centered on a Mozambique mine that RT bought in April 2011 for $3.7 billion, in the hopes that the company could mine coal there and transport it down the Zambezi River.[329] As it turned out, the mine produced inferior coal, and Mozambique

319. 17 C.F.R. § 240.10b–5 (2022).
320. *Id.*
321. *Id.*; *see also* SEC v. Mahabub, 343 F. Supp. 3d 1022, 1047–49 (D. Colo. 2018).
322. 511 U.S. 164, 180 (1994).
323. 564 U.S. 135, 142 (2011).
324. 139 S. Ct. 1094, 1102 (2019).
325. *Id.* at 1100–01.
326. *Id.* at 1103.
327. 396 F.3d 161, 177 (2d Cir. 2005). The plaintiffs in *Lentell* sought to plead a market manipulation claim. *Id.*
328. SEC v. Rio Tinto plc, 41 F.4th 47, 48 (2d Cir. 2022).
329. *Id.* at 50.

declined to permit shipment down the river, leaving only rail transport, which could only be accomplished with $16 billion in infrastructure improvements.[330]

As the Second Circuit summarized it, the Commission alleged that "management from the Mine informed" the RT CEO and CFO on May 11, 2012 that "the Mine's net present value was negative $680 million."[331] Two Controller's Papers prepared for two different RT Audit Committee meetings—held respectively on June 18 and July 30, 2012 and both attended by the CEO and CFO—failed to "identif[y] impairment indicators or record[] impairments."[332] The company submitted an "Impairment Paper" to its outside auditor without any such indicators or impairment.[333] RT filed a Half Year Report on August 9, carrying the Mine at more than $3 billion.[334] The company sold $3 billion in bonds shortly thereafter through documents incorporating that report.[335] A third Controller's Paper prepared for a November 26 Audit Committee meeting "indicated a recoverable value of $4 to $5 billion (which meant that no impairment was likely to be required)."[336]

After an RT valuation team disagreed with the $3 billion mine valuation, that team began a review in August 2012, which culminated in advice in late 2012 to the CEO and CFO "that valued the Mine in the range of *negative* '$4.9 billion to $300 million.'"[337] At a January 15, 2013 meeting the RT board "approved an 80 percent impairment, valuing the Mine at $611 million."[338] A further impairment brought the stated value down to $119 million in 2014, and RT sold the Mine in October 2014 for $50 million.[339]

The case thus revolved around RT's failure to take the impairment earlier than it did.[340] The trial court dismissed the Rule 10b-5(a) and (c) claim in the case and refused to reconsider that dismissal after the Supreme Court issued its *Lorenzo* opinion, the district court finding "no allegation that the Rio Tinto defendants disseminated false statements; the SEC alleged 'only that [the defendants] failed to prevent misleading statements from being disseminated by others.'"[341]

Affirming the order denying reconsideration,[342] the Second Circuit panel held that *Lorenzo* did not abrogate *Lentell*.[343] Acknowledging that "ramifications or

330. *Id.*
331. *Id.*
332. *Id.*
333. *Id.*
334. *Id.*
335. *Id.* at 51.
336. *Id.*
337. *Id.* (emphasis by the court) (quoting App'x).
338. *Id.*
339. *Id.*
340. *Id.*
341. *Id.* at 51–52 (quoting SEC v. Rio Tinto plc, No. 17 Civ. 7994, 2021 WL 818745, at *2 (S.D.N.Y. Mar. 3, 2021)) (quotation at 52). An early district court opinion in the case recites the twelve claims in the SEC's complaint. SEC v. Rio Tinto plc, 17 Civ. 7994 (AT), 2019 WL 1244933, at *7–21 (S.D.N.Y. Mar. 18, 2019). The Second Circuit decision addresses only two—the Rule 10b-5(a) and (c) claim and the Securities Act section 17(a)(1) and (3) claim. *Rio Tinto*, 41 F.4th at 49. The text summarizes the opinion on the first and *infra* note 347 summarizes the opinion on the second.
342. *Rio Tinto*, 41 F.4th at 49, 55.
343. *Id.* at 53.

inferences from *Lorenzo*" might "blur the distinctions between the misstatement subsection[] [Rule 10b-5(b)] and the scheme subsections [(a) and (c)] . . . ," the panel found that *Lorenzo*'s assumption that *Janus* retained vitality showed that *Lorenzo* "preserved the lines between the subsections."[344] And the panel concluded doing so was important for private cases because (i) "overreading . . . *Lorenzo* might allow private litigants to repackage their misstatement claims as scheme liability claims to 'evade the pleading requirements imposed in [private] misrepresentation cases'" and (ii) effectively permit plaintiffs in private cases to pursue under subsections (a) and (c) those who were simply aiders and abettors of a (b) violation by another, thereby evading *Central Bank*.[345] Most importantly, "[m]aintaining distinctions between the subsections of Rule 10b-5 . . . is consistent with the text."[346] As the Second Circuit majority summed it: "*Lentell* tells us that misstatements and omissions alone are not enough for scheme liability, and *Lorenzo* tells us that dissemination is one example of *something extra* that makes a violation a scheme."[347] Accordingly, "the district court did not abuse its discretion when it declined to reconsider the dismissal of the scheme liability claims in light of *Lorenzo*."[348]

8. Materiality

In many instances, securities law disclosure requirements apply only to material facts.[349] In the context of a securities purchase, a fact is material "'if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding'" whether to make the purchase, taking into account whether the fact "significantly altered the 'total mix' of information" otherwise available and relevant to the decision to buy or not.[350] A claim under Rule 10b-5 based on a false or misleading statement requires that the action be based on either a false *material* fact or the omission of a *material* fact necessary for the statements made to avoid misleading.[351] Securities Act sections 11 and 12(a)(2) incorporate the

344. *Id.* at 53–54.

345. *Id.* at 55 (quoting *In re* Alstom SA, 406 F. Supp. 2d 433, 475 (S.D.N.Y. 2005)).

346. *Rio Tinto*, 41 F.4th at 54.

347. *Id.* (emphasis added).

The district court order had also denied reconsideration of the district court ruling dismissing the SEC claim under Securities Act section 17(a)(1) and (3), and the Second Circuit affirmed that part of the district court order as well. *Id.* at 48, 55. Like Rule 10b-5, section 17(a) includes three subsections, only the *second* of which imposes liability for false statements of material facts and statements that mislead because they omit material facts. 15 U.S.C. § 77q (2018). Thus, the same textual argument that the Second Circuit employed in its Rule 10b-5 analysis applied to section 17(a)—that the statute had three subsections, only one of which spoke of liability for a false or misleading "statement" and that therefore "[m]aintaining distinctions between the subsections of . . . Section 17(a) is consistent with the text." *Rio Tinto*, 41 F.4th at 54.

348. *Rio Tinto*, 41 F.4th at 55.

349. 1 Thomas L. Hazen, Treatise on the Law of Securities Regulation § 3:10 (2022).

350. Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976)).

351. 17 C.F.R. § 240.10b-5(b) (2022).

same materiality element in the same way when imposing liability under those provisions for false or misleading representations.[352]

Last year, the Ninth Circuit affirmed dismissal in a case challenging statements about an issuer's growth and market in China, finding multiple statements puffery.[353] The Tenth Circuit held that most statements about an issuer's sales force were immaterial but that a representation concerning the number of quota-bearing sales personnel could be material, given that the company had identified billings growth as its key business metric and given the relationship to that metric of the company's productive salesforce headcount.[354]

Puffery. In *Macomb County Employees' Retirement System v. Alignment Technology, Inc.*, the Ninth Circuit applied the definition of materiality to "distinguish between corporate braggadocio and genuinely false or misleading statements."[355] Align Technology, Inc. ("Align") produced clear plastic braces.[356] Largely driven by sales in China, Align's year-over-year revenue grew from between 70 percent to 100 percent in every quarter in 2017 and 2018.[357] Revenue continued to grow in 2019 but at a slower rate, falling to between 20 percent and 30 percent in the second quarter of that year, and Align's stock price declined.[358] Investors brought a Rule 10b-5 claim against the company and senior executives, alleging that the defendants "'misrepresent[ed]' Align's growth in China throughout the second quarter of 2019, claiming strong numbers despite knowing (or recklessly disregarding) that the growth rate in China had slowed significantly."[359] The plaintiffs focused on twelve statements.[360]

Although affirming district court dismissal,[361] the Ninth Circuit found that the complaint "alleged sufficient evidence to support the inference that Align's growth in China had slowed materially when the challenged statements were made in late April, May, and June 2019."[362] Nevertheless, six of the statements were non-actionable "'puffery' . . . 'expressing an opinion' that is not 'capable of objective verification.'"[363] These included answers to analyst questions during an April 24, 2019 earnings call that "'[w]e still have a great business in APAC [Asia Pacific] from a growth standpoint overall,' and 'China is a great growth market for us'" and a June 5, 2019 description at a healthcare conference of China "as 'a

352. 15 U.S.C. §§ 77k(a), 77*l*(a)(2) (2018).
353. *See infra* notes 355–74 and accompanying text.
354. *See infra* notes 375–93 and accompanying text.
355. 39 F.4th 1092, 1095 (9th Cir. 2022).
356. *Id.*
357. *Id.*
358. *Id.*
359. *Id.* at 1096.
360. *Id.*
361. *Id.* at 1095, 1101.
362. *Id.* at 1098.
363. *Id.* (quoting Retail Wholesale & Dep't Store Union Local 338 Ret. Fund v. Hewlett-Packard Co., 845 F.3d 1268, 1275 (9th Cir. 2017) (quoting Or. Pub. Emps. Ret. Fund v. Apollo Grp. Inc., 774 F.3d 598, 606 (9th Cir. 2014))).

market that's growing significantly for us' with '[g]reat economics.'"[364] The court of appeals reasoned that such "'vague statements of optimism like "good," "well-regarded," or other feel good monikers, are not actionable because professional investors, and most amateur investors as well, know how to devalue the optimism of corporate executives.'"[365] Important to this holding, however, was that "at the time Align's executives made the six challenged statements, the company's sales were still growing in China, albeit at a diminished rate, so these feel-good descriptions from Align's executives did not 'affirmatively create[] an impression of a state of affairs that differ[ed] in a material way from the one that actually exist[ed].'"[366]

The Ninth Circuit held that the remaining six statements could not support a Rule 10b-5 claim because the complaint did not plead them false or misleading.[367] As to three, "the complaint contains no allegations contrary to the assertions" that the statements contained.[368] In a fourth, the Align CFO, "in response to an analyst question about competitors absorbing market share over a period of several years, . . . stated, 'whether it's in China or U.S. or other places, we've been competing against many of these companies that I mentioned for a number of years and still been able to grow as we have.'"[369] Since "grow as we have" referred in context to "Align's historical growth rate in China over at least the prior year if not longer," it was "an accurate assessment" of that "past growth."[370] A fifth statement by the CEO responded to a question about a competitor so: "'Straumann's [the competitor] move with third- or fourth-tier player from a clear aligner standpoint, I don't see that as dramatic effect on this market now or in the immediate future at all.'"[371] The complaint "failed to plead sufficient facts to establish that this particular competitor's presence in China caused the slowdown in Align's growth, especially considering that the complaint referenced at least two other competitors in addition to Straumann (SmileDirectClub and Angel Align) that were putting pressure on Align in China."[372] The sixth statement appeared in the 10-Q that Align filed on May 2, 2019: "'Demand for our products may not increase as rapidly as we anticipate due to a variety

364. *Id.* at 1099. The other four statements were (i) an affirmation at a May 14, 2019 healthcare conference that "'China . . . gets a lot of attention. And rightly so, it's a huge market opportunity for us'"; (ii) a response to an analyst question on May 29, 2019: "'we see tremendous growth in APAC, in China in particular'"; (iii) another response on the same day: "'we're seeing tremendous growth'"; and (iv) a statement on that day: "'[t]he dynamics in China are really good for us . . . . [T]he appetite for growth and new technology adoption in China has been great for us. And as you mentioned, the economics work well for us.'" *Id.*

365. *Id.* (quoting Police Ret. Sys. of St. Louis v. Intuitive Surgical, Inc., 759 F.3d 1051, 1060 (9th Cir. 2014) (internal quotation marks omitted) (quoting *In re* Cutera Sec. Litig., 610 F.3d 1103, 1111 (9th Cir. 2010))).

366. *Id.* (alteration in original) (quoting *In re* Quality Sys., 865 F.3d 1130, 1144 (9th Cir. 2017) (quoting Brody v. Transitional Hosps. Corp., 280 F.3d 997, 1006 (9th Cir. 2002))).

367. *Id.* at 1099–1100.

368. *Id.* at 1099.

369. *Id.*

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

371. *Id.* at 1100 (alteration in original); *id.* at 1099 (identifying officer's position).

372. *Id.* at 1100.

of factors including a weakness in general economic conditions.'"[373] Since the plaintiff had not even bothered to contend on appeal that this representation could support the Rule 10b-5 claim, the Ninth Circuit found any such argument waived.[374]

Specific statement about number of quota-bearing sales personnel. In a somewhat similar case, the Tenth Circuit affirmed in part but reversed in part a dismissal, holding that one alleged representation was sufficiently specific to be materially misleading while the other challenged statements were either generalized puffery or were not attacked with factual allegations to show that they were false.[375]

Pluralsight, Inc. ("Pluralsight") "told investors and analysts that Pluralsight's sales force—including both the number of its sales representatives and their productivity—was the primary driver of Pluralsight's billings growth" and "repeatedly stated that billings growth was Pluralsight's 'key business metric.'"[376] On July 31, 2019, the company disclosed a decline in quarterly billings growth to 23 percent in the second quarter of that year, as compared to more than 40 percent in each of the preceding five quarters and acknowledged that this resulted from the company's failure to add the planned number of additional sales personnel in the early part of the year—i.e., "until, kind of, early[-] to mid[-]second quarter."[377] Pluralsight's stock price declined by about 40 percent.[378]

Investors brought a Rule 10b-5 claim against the company, the CEO, and the CFO; and Securities Act section 11 and 12(a)(2) claims against them and all directors who had signed a registration statement for an offering in March 2019.[379] The putative class for the Rule 10b-5 claims consisted of those who acquired Pluralsight stock between January 16 and July 31, 2019, and the class for the Securities Act claims consisted of those who could trace their stock to the March offering.[380]

The complaint pled that eighteen statements were false or misleading in light of the number of the company's sales force and the delay in increasing it.[381] After the district court dismissed the entire case, the Tenth Circuit held that the plaintiffs adequately pled one statement false.[382] In that one statement, the Pluralsight CFO said in a January 16, 2019 earnings call that the "'aggregate quota-bearing

373. *Id.*
374. *Id.*
375. Ind. Pub. Ret. Sys. v. Pluralsight, Inc., 45 F.4th 1236, 1243, 1271–72 (10th Cir. 2022).
376. *Id.* at 1243–44.
377. *Id.* at 1245–46 (quoting CFO, whom the opinion identified at 1242).
378. *Id.* at 1246.
379. *Id.* at 1242, 1246.
380. *Id.* at 1246. The complaint also alleged an Exchange Act section 20A claim for insider trading against the CFO and the CEO. *Id.*
381. *Id.* at 1242.
382. *Id.* at 1248. The lower court had also found this statement pled false but concluded that the complaint failed to plead sufficient facts to create a strong inference that this statement was made with scienter, a conclusion with which the Tenth Circuit disagreed. *See infra* notes 388–91 and accompanying text.

sales reps went from about 80 [in recent years] to today we have about 250.'"[383] The complaint pled that false "given [the CFO's] later statement in January 2020 that Pluralsight had only 200 quota-bearing sales representatives coming into 2019."[384] Moreover, the CFO said on July 31, 2019 that Pluralsight "only had 'about 250 quota-bearing reps *right now*,' because it had been 'dozens of reps' behind until 'early[-] to mid[-]second quarter' of 2019"—which the court interpreted as admitting that the company had not had that number back in January.[385]

The defendants did "not contest the materiality" of the "about 250" representation.[386] Nor, in the Tenth Circuit's view, could they, given that (i) the company itself had proclaimed that the number of its sales force was important in driving what Pluralsight identified as the key metric of billings growth and (ii) the allegations that "analysts consistently asked about Pluralsight's sales force numbers, relayed [the CFO's] representations in their reports to investors, and factored [his] statements into their investment recommendations."[387]

The Tenth Circuit also held that the complaint pled sufficient facts to allege that the CFO made the misrepresentation on January 16 with scienter.[388] The panel interpreted the CFO's remarks on July 31, 2019 and in January 2020 as "support[ing] the inference that in January 2019 [he] already knew that Pluralsight had only 200, not about 250, quota-bearing representatives."[389] In addition, "[t]he complaint allege[d] [that the CFO] consistently represented to analysts and investors that he carefully monitored sales force data, including the number of sales representatives and their productivity," and the CFO knew that "investors consistently asked him about the size of the sales force at conferences and during earnings calls."[390] Moreover, during the class period, the CFO sold almost 40 percent of his Pluralsight stock for some $519,000, while he sold stock for only about $19,000 afterward.[391]

383. *Id.* at 1250 (quoting Aplts. App'x, Vol. 1, at 105–06).

384. *Id.*; *see also id.* at 1246 (CFO specifically stated at a January 2020 conference "that Pluralsight 'came out of 2018 going into 2019 with about 200 quota-bearing sales reps.' 'We came into the year with fewer sales reps than we had planned—than we had hoped for.' 'We just didn't have enough reps.'" (record citations omitted)).

385. *Id.* at 1250 (quoting Aplts. App'x, Vol. 1, at 82).

386. *Id.* at 1251.

387. *Id.*

388. *Id.* at 1258–69. The court of appeals emphasized that it was limiting its opinion to that one remark by the CFO. *Id.* at 1259 n.11.

389. *Id.* at 1260. The opinion observed that he "never claimed he was unaware of the problem" and observed that "Defendants' counsel effectively conceded that [the CFO] would have known the number of quota-bearing sales representatives in January 2019." *Id.* at 1260, 1264 n.13.

390. *Id.* at 1263–64.

391. *Id.* at 1267. The CFO argued that the court should draw no scienter inference from his stock sales because they were made pursuant to a Rule 10b5-1 plan. *Id.* at 1265. But, because "a defendant who knows the schedule of their 10b5-1 plan could be motivated to make material misrepresentations affecting the stock price to their benefit before a scheduled sale or to trigger a sale at a particular price," the court held "the mere fact that a trade was made under a 10b5-1 plan does not per se rebut the inference of scienter where, as here, a defendant was allegedly motivated to mispresent or withhold material information to affect a stock price in anticipation of a previously scheduled trade." *Id.* at 1266.

As to the remaining statements, the Tenth Circuit found some inactionable puffery—Pluralsight "was 'seeing some of the efficiencies in [its sales] model'"; the company had "'built out some of the infrastructure around sales to scale'"; it "'had a lot of great sales reps. They're killing it'"; it expected "more goodness" from the sales force; it had "'been able to drive substantial increases in the productivity and effectiveness of our sales personnel over time as they gain more experience selling subscriptions to our platform'"; it had "'significantly expanded our direct sales force to focus on business sales'"; and, on May 1, 2019, that Pluralsight was then "'on pace . . . to having 300-plus reps by the time we exit the year.'"[392] As for plaintiffs' contention that four risk factors—set out in the company's 10-K filed in February 2019 and included in offering documents for Pluralsight's March offering and a 10-Q it filed in May—misled because they warned of risks that had already materialized, the Tenth Circuit concluded that "even if Pluralsight had already fallen behind its sales ramp capacity plan by February 2019, that problem could still be remedied at the time Pluralsight disclosed the risk to investors" and found "nothing in the complaint support[ing] the inference that Defendants knew Pluralsight was so far behind in its sales ramp capacity plan that it was virtually certain to cause harm to the business."[393]

9. False or Misleading Statements

For a statement to violate Rule 10b-5, or section 11, or section 12(a)(2), it must not only be material but also false or misleading.[394] Last year, the Fourth Circuit affirmed dismissal of a Rule 10b-5 action in which the plaintiffs challenged statements by a hotelier concerning a cybersecurity breach, finding insufficient facts alleged to show false or misleading the defendants' statements that (i) protection of customer data was important; (ii) the hotelier had sought to protect that data; and (iii) a breach was possible, coupled with—after the breach at issue—a further statement that the hotelier had "experienced cyber-attacks."[395] The First Circuit affirmed dismissal of a Rule 10b-5 action constructed around post-acquisition representations about a pharmaceutical business made while the acquiring company incrementally wrote down the goodwill associated with that business.[396]

The Tenth Circuit simply repeated the facts in text accompanying *supra* notes 389–91 in performing its "holistic" review of the scienter allegations. *Id.* at 1267–69.

392. *Id.* at 1251–52, 1253–54, 1257–58.

393. *Id.* at 1254–57.

The plaintiffs pled that Pluralsight violated Regulation S-K Item 303(b)(2)(iii). *Id.* at 1269; 17 C.F.R. § 229.303(b)(2)(iii) (2022). The Tenth Circuit remanded for consideration of whether violation of that Item could support a Rule 10b-5 claim and whether the alleged gap in sales force ramping during the first part of 2019 constituted a "trend" within the meaning of Item 303(b)(2)(iii). *Pluralsight, Inc.*, 45 F.4th at 1270–71. The court commented that violation of Item 303 might support a Securities Act claim and that the remand should consider that as well. *Id.* at 1271.

394. See *supra* notes 351 & 352 and accompanying text.

395. *See infra* notes 397–414 and accompanying text.

396. *See infra* notes 415–36 and accompanying text.

Cybersecurity failure. In November 2018, Marriott International, Inc. ("Marriott") disclosed a security breach putting 500 million guest records from its Starwood hotels at risk.[397] Investors brought a Rule 10b-5 claim against the company and officers and directors, challenging seventy-three statements they made before announcing the breach.[398] In affirming district court dismissal,[399] the Fourth Circuit divided those statements into three categories and held that the complaint did not adequately allege that any of them were false or misleading.[400]

First, Marriott stated that data protection was important. But those statements were not false for failing to "disclose severe vulnerabilities in Starwood's IT systems" because the affirmations of privacy protection's salience "did not 'assign a quality to Marriott's cybersecurity that it did not have.'"[401] Moreover, "Marriott repeatedly warned [that it] may 'fail[] to keep pace with developments in technology'; its systems 'may not be able to satisfy' the 'information, security, and privacy requirements' imposed by laws and regulations; and there were risks of 'significant theft, loss, or fraudulent use of' company and customer data and '[b]reaches in the security of our information systems.'"[402] As a result of such warnings, no "reasonable reader of Marriott's public statements [could] have understood the company to be overrepresenting the extent to which it was 'securing and protecting the customer data.'"[403]

Second, Marriott's statement that it sought to protect guests' personal data and invested in efforts to secure that data failed to support a claim.[404] "[T]he complaint concede[d] that Marriott devoted resources and took steps to strengthen the security of Starwood's systems."[405] And Starwood "cautioned" on its website "that '"guaranteed security" does not exist either on or off the Internet.'"[406] Similarly, the "remaining privacy statements" that the complaint challenged "were

397. Marriott Int'l, Inc., Press Release (Form 8-K), exh. 99 (Nov. 30, 2018), https://www.sec.gov/Archives/edgar/data/1048286/000162828018014745/a2018ex99.htm (Marriott Announces Starwood Guest Reservation Database Security Incident). A little over a month later, the company reduced the number of potential exposures, stating that the company had "identified approximately 383 million records as the upper limit for the total number of guest records that were involved in the incident." Marriott Int'l, Inc., Press Release (Form 8-K), exh. 99 (Jan. 4, 2019), https://www.sec.gov/Archives/edgar/data/1048286/000162828019000090/mar201901ex99.htm (Marriott Provides Update on Starwood Database Security Incident).

398. *In re* Marriott Int'l, Inc., 31 F.4th 898, 901 (4th Cir. 2022).

399. *Id.* at 902, 905.

400. *Id.* at 902–05.

401. *Id.* at 901, 902–03 (quoting Joint App'x); *id.* at 903 ("Marriott made no characterization at all with respect to the quality of its cybersecurity, only that Marriott considered it important.").

402. *Id.* at 903.

403. *Id.* (quoting plaintiff's brief).

404. *Id.* (providing as examples a statement on Marriott's website that "it 'seek[s] to use reasonable organizational, technical and administrative measures to protect'" personal data, while noting that "'no data transmission or storage system can be guaranteed to be 100% secure,'" and that Starwood's "'web sites and servers have security measures in place to help protect your personal data.'" (quoting Joint App'x)).

405. *Id.*

406. *Id.*

accompanied by such sweeping caveats that no reasonable investor could have been misled by them."[407]

Third, while Marriott disclosed data breach risks, the plaintiff contended the company "twice warned generally about events that could occur when it knew those events *had in fact* already occurred."[408] In the first instance, the plaintiff alleged that Marriott said it was possible that it might not be capable of satisfying standards promulgated by the credit card industry while knowing that it was not meeting those standards.[409] But the complaint alleged only that a consultant "reported that Starwood's '[b]rand standards did not mandate PCI compliance,' not that Starwood's systems were, in fact, not compliant" so that the report said only "that Starwood's systems might not satisfy PCI DSS requirements—which is what Marriott stated in its risk disclosures."[410] In the second instance, the plaintiff charged that *after* learning of the data breach at issue in the case, "Marriott's SEC disclosures from November 6, 2018 'warned generally of the risk that Marriott could face disruptive cyber security incidents,' such as '[e]fforts to hack or circumvent security measures' and 'attempts to affect the integrity of our data.'"[411] But, in fact, "after learning of the breach, Marriott updated its disclosure to state: '[W]e have experienced cyber-attacks, attempts to disrupt access to our systems and data, and attempts to affect the integrity of our data, and the frequency and sophistication of such efforts could continue to increase.'"[412]

Significance and analysis. *Marriott* contrasts with the lawsuit against Alphabet, Google's parent, in which the Ninth Circuit in 2021 held the plaintiff had adequately pled a Rule 10b-5 claim that Alphabet's 10-Qs had misled because they stated that there had been no material changes in the company's risk factors addressing cybersecurity since it had filed its 10-K even though the company had 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.[413] But the claim against Alphabet differed from that against Marriott in that the complaint against Alphabet included a lengthy and specific chronology that featured internal consideration of whether to disclose the breach and a supposed decision not to do so, which the company only reversed after a *Wall Street Journal* article brought the cyber penetration to light.[414]

Customer loss at acquired business; value of that business during incremental write-down. CVS Health Corporation ("CVS") acquired Omnicare Inc.

407. *Id.*; and see the caution recited in *supra* note 404.
408. *In re Marriott Int'l, Inc.*, 31 F.4th at 904 (emphasis by the court).
409. *Id.*
410. *Id.* (quoting Joint App'x).
411. *Id.* (quoting Plaintiff's brief).
412. *Id.* at 905 (quoting Marriott Int'l, Inc., Quarterly Report (Form 10-Q), at 50 (Nov. 6, 2018), https://www.sec.gov/Archives/edgar/data/1048286/000162828018013710/mar-q32018x10q.htm).
413. *In re* Alphabet, Inc. Sec. Litig., 1 F.4th 687, 695–96 (9th Cir. 2021), *cert. denied*, 142 S. Ct. 1227 (2022) (mem.).
414. *Id.* at 695–98.

("Omnicare") in 2015.[415] Omnicare provided pharmaceutical services to long-term care facilities (the "LTC business").[416] CVS subsequently wrote down the goodwill associated with the LTC business in a series of steps beginning in November 2016 and ending with a February 2019 announcement of Q4 2018 financials—a decline from $8.6 billion at the time of the deal to $431 million by the close of 2018.[417] Plaintiffs filed a Rule 10b-5 claim against CVS and officers alleging that the defendants made what the First Circuit grouped into five categories of assertedly false or misleading statements during a class period stretching from February 2016 through the announcement of the last write-down.[418]

Affirming dismissal,[419] the First Circuit held that the complaint "fails to allege sufficiently specific facts about the state of the LTC business at particular points in time to enable us to conclude that any of the goodwill write-downs were too late or that any of defendants' alleged misstatements contradicted the state of that business as it then stood."[420]

First, the plaintiffs attacked statements about the state and financial results of the LTC business, such as the representations in a CVS 10-K filed in February 2016 (and in periodic filings for the rest of the year) that CVS "'segments benefited from the Omnicare acquisition'" and that net revenues in the segment into which the LTC business had been integrated were higher, and "'primarily driven by the acquisition of Omnicare.'"[421] The complaint asserted that "these statements were misleading because they gave a positive impression of the business without disclosing that Omnicare LTC customers were fleeing."[422] Second, the plaintiffs challenged statements by the CVS officers in 2016 and 2017 that CVS, through Omnicare, was a leader in the LTC market.[423] Again, the complaint argued that these amounted to fraud "because they omitted information about customer exodus."[424]

Third, the plaintiffs averred that CVS misled by statements about its understanding of LTC customers—e.g., "tout[ing] CVS Health's 'deep understanding of [consumers', payors', and providers'] diverse needs,'" "'[w]ork[] with our LTC clients to address currently unmet needs of their residents,'" and "'invest[ment of] the time and capital . . . to get the right technology and processes in place in order to differentiate our offering to make it more compelling for our clients as well as the

415. City of Miami Fire Fighters' & Police Officers' Ret. Tr. v. CVS Health Corp., 46 F.4th 22, 26 (1st Cir. 2022). CVS accomplished the acquisition through its subsidiary, CVS Pharmacy, Inc. *Id.* at 26 n.1.

416. *Id.* at 26.

417. *Id.* at 26–27.

418. *Id.* at 27, 29 & n.5.

419. *Id.* at 26, 38.

420. *Id.* at 27–29, 31.

421. *Id.* at 27–28 (quotations from CVS SEC filings).

422. *Id.* at 28 (court's summary).

423. *Id.*

424. *Id.* (court's summary).

residents at these facilities.'"[425] Such claims, the complaint contended, "were false and misleading because defendants did not in fact understand their LTC customers' needs and many of these customers were fleeing CVS Health due to poor customer service."[426]

Fourth, the complaint labeled false claims of realized or anticipated synergies from the acquisition, on the grounds that "it was in fact the 'synergies' implemented by CVS Health that caused LTC customers to leave."[427] Fifth and finally, the plaintiffs alleged that the risk warnings in CVS's SEC filings—cautioning, for example, that the company could not assure investors that existing business would be renewed and that integration problems could create difficulties in retaining customers—"misleadingly purported to alert investors to only future risks that were, in fact, 'already occurring.'"[428]

Since all of the attacks centered on the failure to disclose loss of LTC customers, the court then attempted to match the timing of the challenged statements against the timing of customer loss that the complaint contained.[429] The court could find only six allegations that tied customer loss to dates within the class period.[430] Two of them—referring respectively to a competitor taking customers in unspecified number "'since 2015'" and a regional Omnicare division losing customers "'from 2015 to 2019'"—"cover[ed] such broad swaths of time that they effectively provide no date limitation."[431]

The other four "paint[ed] with only a slightly finer brush"—"one competitor poached customers 'in 2015,' two others did so 'in 2016,' and an Omnicare affiliate pharmacy in New York lost most of its customers 'immediately after the Acquisition' such that a particular site of that affiliate closed '18 months after the Acquisition.'"[432] But only the alleged customer decline in 2015 dated before the first CVS write-down (in November 2016), and the complaint did not allege facts providing any "reason to think that that 2015 loss by itself was both material and not offset by new business."[433] As to alleged customer departures in 2016, the complaint did not include facts to show that these were "anything but consistent with the general negative trend of CVS Health's goodwill write-offs beginning in 2016 and its statement in 2017 that issues with 'client retention rates' contributed to declining revenues in the prior year."[434]

Overall, then, "[p]laintiffs' failure to establish a reasonably clear timeline of customer losses inconsistent with the company's goodwill disclosures is representative of the complaint's overarching failure to allege material facts

425. *Id.* (most alteration in original) (quotations from CVS SEC filings and CEO remarks on investor calls).
426. *Id.* (court's summary).
427. *Id.* (court's summary).
428. *Id.* at 28–29 (quoting plaintiffs).
429. *Id.* at 31–33.
430. *Id.*
431. *Id.*
432. *Id.* at 32 (quoting appellate brief).
433. *Id.*
434. *Id.*

inconsistent with defendants' public statements."[435] Nor did the complaint fare better if interpreted not as a challenge to CVS affirmations but as one based on omission of facts related to customer loss, as that theory "provides too little basis for comparing any material conclusions implied by the statements against the contemporaneous state of the LTC business."[436]

10. Scienter and Scienter Pleading

A Rule 10b-5(b) violation requires not only that a fact be misstated or misleadingly omitted and that the fact be material, but also that the misstatement or omission be made with scienter—i.e., either an intent to defraud or recklessness as to whether it will mislead.[437] In a private lawsuit seeking Rule 10b-5 damages, the Exchange Act requires that the plaintiff must plead facts raising a "strong inference" of this guilty state of mind.[438] In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court interpreted this statutory mandate to mean that a complaint must plead facts that support "an inference of scienter" that is "more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[439]

K12, Inc. ("K12") "furnishe[d] schools with curricula, administrative support, virtual-learning software, and other educational services."[440] Anticipating an increase in business resulting from school closures due to the COVID virus, the company and top officers made bullish statements around its April 27, 2020

435. *Id.* at 33. The First Circuit found other pleading defects. While the plaintiffs challenged CVS statements that Omnicare was, after the acquisition, a market leader, "the complaint never alleges that Omnicare was in fact not the market leader—even by the end of the class period, long after these statements were made." *Id.* (emphasis by the court). Similarly, the challenge to statements that the CVS business segment into which Omnicare was folded had added to net revenue shortly after the acquisition failed for want of an allegation "that the Omnicare acquisition in fact failed to contribute substantial revenue." *Id.* Such statements as that CVS had invested time and money were also unchallenged by contradicting particulars. *Id.* at 33–34. The claim that references to "synergies" constituted fraud was unsupported by any "specific instance where a defendant claimed—contrary to then-existing facts—that a particular business operation was succeeding." *Id.* at 34. Finally, addressing the challenge to CVS risk warnings as failing to disclose that risks had actually materialized by the first such warning in February 2016, the First Circuit found the complaint bereft of "the information necessary to infer that there was any material net loss of customers that was not timely reflected in the 2016 write-off." *Id.* at 35.

436. *Id.* at 34–35.

Also addressing in 2022 whether statements were false or misleading, the Sixth Circuit reversed dismissal of Rule 10b-5 claims against a CEO and his company, where the CEO provided favorable reports on the performance of modular factories that his company sold, represented that there was "no risk" of one customer failing to pay even though the operation of the factory sold to that customer failed to satisfy European environmental standards and therefore prevented that customer from accessing the European market, and delayed full disclosure of a clawback agreement with a second customer even though the factory sold to that customer was failing to meet a reliability threshold and the failure would trigger an obligation for the CEO's company to refund the purchase price. City of Taylor Gen. Emps. Ret. Sys. v. Astec Indus., Inc., 29 F.4th 802, 810–12 (6th Cir. 2022).

437. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12 (1976); 3 Hazen, *supra* note 349, § 12:52.

438. 15 U.S.C. § 78u-4(b)(2)(A) (2018).

439. 551 U.S. 308, 314 (2007).

440. Boykin v. K12, Inc., 54 F.4th 175, 180 (4th Cir. 2022).

and August 11, 2020 earnings releases.[441] K12's stock "underwent a months-long climb in tandem with the broader stock market[—[f]]rom a closing price of $25.04 on April 27, . . . to an all-time high of $52.84 on August 5."[442]

Beginning with newspaper stories that the Miami-Dade school district would not go forward with a K12 contract, the company's stock price declined, and after news that another school district had ended its relationship with K12, the stock price "eventually reached a low of $20.39 on December 29."[443] Investors filed a Rule 10b-5 action against K12, its CEO, and its CFO.[444]

Affirming district court dismissal,[445] the Fourth Circuit found some of the alleged misstatements to be immaterial puffery—e.g., K12's "claiming [that] its 'academic experience' had remained 'essentially school as usual' [and] . . . touting its technological 'core competency,' 'expertise,' and 'flexibility.'"[446] Since "[t]he company offered no quantitative metrics, qualitative comparisons, or other specifics" to support such claims, no reasonable investor would have relied on them when deciding whether to buy K12's stock.[447]

The court of appeals found other statements to be opinions—e.g., "'[a]s an innovator in K-12 online education, *we believe* we have attained distinctive core competencies that allow us to meet the varied needs of our school customers and students.'"[448] Besides looking like puffery, that opinion was not, as the Fourth Circuit saw it, pled false under any of the three alternative ways in which an opinion might be false or misleading, as identified in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*.[449] First, plaintiffs did not "deny, in more than conclusory fashion, that K12 'actually h[e]ld[]' its stated belief."[450] Second, "[w]hile it is true that the prefatory clause contain[ed] an embedded assertion—that K12 [was] 'an innovator in K-12 online education'—plaintiffs do not seriously contest this point."[451] Third, "plaintiffs fail[ed] to show that K12's opinion omitted necessary context" because this "opinion was not simply emitted into the ether. It was made within the framework of a 10-K filing, where investors could have parsed the ample disclosures at their fingertips before succumbing to K12's stated view."[452]

The court of appeals determined that still other challenged statements fell within the statutory protection for forward-looking statements—e.g., the K12 CEO's claim "that a shift toward online instruction 'positions us well.'"[453]

441. *Id.* at 180–81.
442. *Id.* at 180.
443. *Id.* at 181.
444. *Id.* at 180 (identifying officers); *id.* at 181–82.
445. *Id.* at 180, 187.
446. *Id.* at 183 (record citations omitted).
447. *Id.*
448. *Id.* at 184 (emphasis by the court) (record citation omitted).
449. *Id.* at 183–84 (citing Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175, 184–86 (2015)).
450. *Id.* at 184.
451. *Id.*
452. *Id.*
453. *Id.*

While that statement "employed the present tense, it [was] apparent from [the CEO's] statement—read as a whole—that he was referring to K12's future prospects 'given how the education market is likely to change,'" and hence was forward-looking.[454]

The heart of the plaintiffs' case, however, was the charge that the defendants misled investors by claiming that K12 had a contract with the Miami-Dade County Public Schools ("Miami-Dade") when, in fact, the company did not.[455] Plaintiffs based this charge on (i) the CEO's statements in an August 11 earnings call that (a), "alluding to a reported deal with Miami-Dade[,] . . . 'K12 will provide customized services, including curriculum, assessment tools, teacher training and data management'" and (b) "'[w]e are seeing [an] increase . . . in school districts who call us and want to use our content and our curriculum with more of those contracts this year than we've ever had in any one year before. I mentioned Miami-Dade, there's others we're working on, not yet disclosed, but maybe not as large as Miami-Dade'"; and (ii) an August 19 interview in which the CEO said "that Miami-Dade was 'using online tools to reach their students.'"[456] Two securities "analysts covering K12 applauded the company, respectively, for having a 'contract signed' and a 'contract win.'"[457]

In fact, K12 and Miami-Dade began negotiations in early July 2020, "with K12 taking steps then 'to set up the platform, integrate its systems, train personnel, and roll out the temporary [software] in time for the first day of school.'"[458] The counterparties agreed on price by July 10.[459] A Miami-Dade "official then announced on July 29 that the district 'intend[ed] to purchase' K12's platform, even specifying the source of funding to be tapped," and Miami-Dade "informed the Florida Department of Education on July 31 that it would be partnering with K12."[460] The company and the district reduced the contract to writing by August 10, and the Miami-Dade superintendent signed the contract on August 17, though he did not return the executed contract to K12.[461] Thus, as the Fourth Circuit put it, "after a long and extended series of negotiations, a contract with Miami-Dade was well on its way when [K12's CEO] made his statements."[462]

454. *Id*. The court of appeals did not say which part of the statutory protection shielded this or any other forward-looking statement from private lawsuits—whether the statements were (i) "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement[s]" or (ii) whether the complaint failed to include facts to raise a strong inference that the statements were made with "actual knowledge" that they were false or misleading. 15 U.S.C. § 78u-5(c) (2018).

455. *K12*, 54 F.4th at 185. As to materiality, while the Miami-Dade contract would have contributed less than 2 percent of K12's yearly revenue, the large number of students in Miami-Dade would have tripled the number of students that K12 had been serving before and, therefore, "[d]rawing all reasonable inferences in plaintiffs' favor, the prospect of the Miami-Dade deal could well have factored into the run-up of K12 shares during the summer of 2020." *Id.* at 184.

456. *Id.* at 181, 185 (record citations omitted).

457. *Id.*

458. *Id.* at 185 (alteration in original) (record citation omitted).

459. *Id.*

460. *Id.* (alteration in original).

461. *Id.*

462. *Id.*

Problems between K12 and Miami-Dade only surfaced *after* the CEO spoke—first in an August 25 news story "quot[ing] a district official as saying K12's platform 'fell below the expectations we set,'" followed by "the leader of the Miami-Dade teachers' union [telling] CBS Miami [on August 26] that K12's training had been 'ineffective,'" a September 2 news story "that the K12 platform had suffered twelve cyberattacks," and finally a September 10 Miami-Dade board vote to terminate the district's relationship with K12.[463]

The Fourth Circuit questioned whether, against this background, the complaint even pled the CEO's statements false, because "plaintiffs nowhere allege that [the CEO], for all his enthusiasm about the Miami-Dade partnership, ever attested unambiguously to having a signed agreement."[464] Without resolving that matter but instead turning to scienter, the court of appeals noted that falsity and scienter are "interrelated," here because the CEO's "statements were not spun from whole cloth."[465] Instead, "[t]he timeline is consistent with his anticipation in mid-August of a consummated deal with Miami-Dade"—which was apparently the view of the Miami-Dade superintendent who actually signed the K12 contract on August 17.[466] Moreover, if the CEO "aimed to inflate K12's share price at all costs, he could have chosen far less ambiguous language than he did."[467] Putting it all together—and considering that the plaintiffs did not plead suspicious insider trading at K12 or that the CEO or CFO "would personally benefit from a special bonus or an impending performance review" by the challenged statements—the "more cogent inference" was "that [the] defendants 'believed they could profit from pandemic-related disruptions and secure the Miami-Dade deal,'" and that a "fraudulent inference" was not "'at least as compelling' as one of innocence."[468]

11. Duty to Disclose

The securities laws do not impose a general obligation to disclose all material facts as soon as an issuer knows them but only to disclose certain facts under certain circumstances.[469] Silence absent a duty to disclose does not violate Rule 10b-5.[470]

In 2022, the Second Circuit affirmed dismissal of an action to the extent it was based on an issuer's failure to disclose its role in positive online articles touting its stock but reversed dismissal insofar as the action rested on the issuer's failure to disclose an SEC investigation after the issuer had revealed material weaknesses

463. *Id.* at 181.
464. *Id.* at 185.
465. *Id.* at 186.
466. *Id.*
467. *Id.*
468. *Id.* at 186–87.
469. *See* Gallagher v. Abbott Labs., 269 F.3d 806, 808 (7th Cir. 2001) (securities laws do not create "a system of continuous disclosure"; "firms are entitled to keep silent . . . unless positive law creates a duty to disclose").
470. Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 44–45 (2011).

in internal control over financial reporting.[471] The Ninth Circuit affirmed dismissal of a case based on Twitter's failure to disclose a bug in software that prompted users to download advertisers' apps.[472]

Duty to disclose SEC investigation in light of reported material weaknesses in internal controls. 22nd Century Group, Inc. ("22nd Century") paid authors, directly or through a consulting firm, to publish positive online articles about the company during February through October 2017.[473] 22nd Century also disclosed in a 10-K filed in February 2016 "that its 'internal controls over financial reporting were not effective and that material weaknesses exist[ed] in [its] internal control over financial reporting as it related to segregation of duties,'" repeated that disclosure in all three 10-Qs later that year, reprised this language in the 10-K filed in 2017 with the caveat that 22nd Century was taking remedial steps, and concluded with the 10-Q for the second quarter of 2017, announcing "that it had 'completed the implementation and testing of a remediation plan that was targeted at eliminating our previously reported material weakness in our internal controls over financial reporting primarily resulting from a lack of segregation of duties.'"[474] Investors filed a purported class action against 22nd Century and its former CEO and CFO alleging that the defendants violated Rule 10b-5 by failing to (i) disclose that it had paid for the online articles and (ii) reveal an SEC investigation during the time it publicly acknowledged material weaknesses in its internal controls.[475]

In a mixed decision, the Second Circuit affirmed dismissal of the claim insofar as it was based on failure to make public the role that the company played in preparation and publication of the positive online reports.[476] Addressing first whether the allegations stated a claim under Rule 10b-5(b), the court of appeals relied on the Supreme Court's rule that liability under that subsection may be imposed only on the "maker" of a statement and that "'the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.'"[477] The complaint did not plead facts to place the defendants within this definition because, although it alleged "that '[d]efendants furnished information and language for, prepared, reviewed, approved, and/or ratified the articles,'" it did not "adequately allege that [the CEO, who supposedly '"reviewed, edit[ed], and/or approved" the paid stock promotion articles'] directly wrote the articles, controlled what the authors put into the articles, or even saw them before their publication."[478] And "even if [the CEO] had provided some input on the content of the articles,

471. *See infra* notes 473–85 and accompanying text.

472. *See infra* notes 486–96 and accompanying text.

473. Noto v. 22nd Century Grp., Inc., 35 F.4th 95, 99–100 (2d Cir. 2022), *remanded to* 2023 WL 122305 (W.D.N.Y. Jan. 6, 2023).

474. *Id.* at 100 (alteration in original).

475. *Id.* at 99.

476. *Id.* at 99, 103–05, 106–07, 108.

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

478. *Id.* at 104; *id.* at 100 (bracketed quotations).

the complaint does not support the conclusion that [he] had the 'ultimate authority' necessary to brand him the articles' maker."[479]

The court also found that the stock promotion allegations stated no claim pled under the two other subsections of Rule 10b-5—subsections (a) and (c).[480] The plaintiffs formulated that claim as one of market manipulation, but the Second Circuit found no facts pled "that the market was manipulated by either the information in the articles, the payments to the writers, or the non-disclosure of the payments."[481] Nondisclosure of payment to the online authors for their complimentary articles did "not equate to market manipulation," as, "even *if* the payments were material, which we have determined not to be the case, because defendants were not the articles' 'makers,' they had no responsibility for the payments' disclosure. And there is no allegation that defendants directed the authors not to disclose the payments, or that defendants were anything but indifferent as to whether the authors did so."[482]

Although the Second Circuit affirmed dismissal on the above analysis insofar as the plaintiffs asserted a claim based on the online touting, the court vacated the dismissal insofar as the Rule 10b-5 claim rested on 22nd Century's failure to disclose the SEC investigation during the period its SEC filings reported that the company had material weaknesses in its internal control over financial reporting.[483] The court reasoned that the "[d]efendants had a duty to disclose the SEC investigation in light of the specific statements they made about the Company's accounting weaknesses" because, "once a company speaks on an issue or topic, there is a duty to tell the whole truth" and "the fact of the SEC investigation would directly bear on the reasonable investor's assessment of the severity of the reported accounting weaknesses"—i.e., the materiality of the disclosure about the internal control issue.[484]

Significance and analysis. The *22nd Century* opinion's principal importance lies in its seeming rule that if a company reports a material weakness in internal con-

479. *Id.* at 104. The court also rejected the argument that 22nd Century's identification in its 10-Ks of the company's stock price volatility as one of nineteen risk factors imposed a duty to disclose the company's involvement in the promotional articles. *Id.* In doing so, the court observed that "under § 17(b) of the Securities Act of 1933, an issuer who merely pays an author to write positive articles on a stock does not, without more, violate the Act," and the articles here amounted to little more than republication of company statements in press releases as well as statements by the CEO in earnings calls, presentations, and during conferences. *Id.* at 99–100, 104.

480. *Id.* at 106–07. The rule makes it unlawful, in the purchase or sale of a security, "(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. § 240.10b-5 (2022).

481. *22nd Century*, 35 F.4th at 106.

482. *Id.* at 107 (emphasis by the court).

483. *Id.* at 105–06, 108. The complaint alleged that (i) the investigation was underway in 2016, (ii) continued into 2019, and (iii) was sufficiently serious that (a) 22nd Century had retained counsel, (b) the CFO had met with the SEC in Washington, and (c) the CFO expressed concern that he might lose his license and possibly even be imprisoned. *Id.* at 100–01.

484. *Id.* at 105.

trol over financial reporting[485] and an SEC investigation about that weakness follows, the company must disclose that investigation in its next statement that the weakness exists.

Duty to disclose software problems. Twitter makes its money by selling to advertisers access to Twitter's users, with advertisers paying more for tailored information about users that can be used to target users most likely to be interested in the advertisers' products or services.[486] Twitter's Mobile App Promotion ("MAP") is a special advertising service that permits advertisers to prompt users to download the advertisers' apps, and "is most effective when an advertiser knows information about the user's device settings, such as its operating system or which apps the user has already downloaded."[487] After having highlighted MAP as a key revenue driver, Twitter announced on October 24, 2019 disappointing revenues and disclosed software problems affecting MAP.[488] Twitter's stock price lost more than 20 percent.[489]

Plaintiffs filed a Rule 10b-5 lawsuit against the company and two executives, alleging that they committed securities fraud from July 26, 2019 through October 23, 2019 by failing to disclose the MAP software problems and, specifically, that statements in a July 26, 2019 shareholder letter and a Form 10-Q that Twitter filed on July 31, 2019 were false or materially misleading for failing to tell investors of those problems.[490] Affirming dismissal,[491] the Ninth Circuit pronounced broadly that "[s]ecurities laws . . . do not require real-time business updates or complete disclosure of all material information whenever a company speaks on a particular topic. To the contrary, a company can speak selectively about its business so long as its statements do not paint a misleading picture."[492]

Specifically as to the July 2019 shareholder letter and 10-Q, the plaintiffs "argue[d] that Twitter's failure to disclose the software bugs' impact on MAP in [that month] was materially misleading because its prior statements had allegedly left a 'misimpression' that the work to improve MAP was 'on track.'"[493] But the "shareholder letter and 10-Q stated that Twitter is 'continuing [its] work to increase the stability, performance, and flexibility of [its] ads platform and [MAP] . . . but we're not there yet.' Similarly, the CFO explained that the company is 'still in the middle of that work' relating to MAP."[494] The court

485. The company is required to do so if management's internal assessment of internal controls—to which an outside auditor must attest if the issuer is an accelerated filer or a large accelerated filer—reveals such a weakness. 17 C.F.R. § 229.308(a)(3) & (4) (2022).

486. Weston Fam. P'ship LLLP v. Twitter, Inc., 29 F.4th 611, 615 (9th Cir. 2022).

487. *Id.*

488. *Id.* at 616.

489. *Id.*

490. *Id.*

491. *Id.* at 615, 623.

492. *Id.* at 615.

493. *Id.* at 620.

494. *Id.* (alteration in original). The court here provides an imprecise pastiche. The shareholder letter included that Twitter was "also continuing our work to increase the stability, performance, and flexibility of our ads platform and mobile application download product." *See* Twitter, Inc., Current Report (Form 8-K), exh. 99.1 (July 26, 2019), https://www.sec.gov/Archives/edgar/data/

found “none of these statements [to] suggest[] that Twitter’s MAP program was ‘on track,’” rather “a vaguely optimistic assessment that MAP, like almost all product developments, ha[d] had its ups and downs, even as the company continue[d] to make progress.”[495] These “qualified and vague” pronouncements imposed “no legal duty to disclose immediately the software bugs in its MAP program.”[496]

12. Forward-Looking Statements

Both the Securities Act and the Exchange Act protect forward-looking statements, which include “projections of revenues” or “income” and “statement[s] of future economic performance,” as well as the “assumptions underlying” them.[497] With certain exceptions not applicable to the case discussed below, a private plaintiff cannot recover damages, based on such a statement, in a lawsuit under either act against a public company issuer or a person acting on its behalf if either (a) the statement was accompanied by cautionary language “identifying important factors that could cause actual results to differ materially from those in the forward-looking statement” or (b) the plaintiff cannot prove that the statement was made with actual knowledge that it was false or misleading.[498]

Axogen, Inc. (“Axogen”) produced what it characterized as “peripheral nerve repair and protection solutions.”[499] During a class period stretching from August 7, 2017 to December 18, 2018, Axogen stated in prospectuses, registration statements, and periodic Exchange Act filings that it “believe[d] each year in the U.S. more than 1.4 million people suffer traumatic injuries to peripheral nerves” and that it “believe[d]” or “estimate[d]” that these injuries “result[ed] in over 700,000 extremity nerve repair procedures.”[500] After a short seller reported only 28,000 as the true annual number of peripheral nerve injury repair procedures in the

1418091/000156459019026245/twtr-ex991_7.htm (Twitter Q2 Shareholder Letter). The “we’re not there yet” and “still in the middle of that work” comes from an answer given by CEO Jack Dorsey during a conference call with analysts on July 26, 2019. *See* Jack Dorsey, Chief Executive Officer, Twitter, Inc., Twitter, Inc. Q2 2019 Earnings Call (July 26, 2019) (transcript available at The Motley Fool), https://www.fool.com/earnings/call-transcripts/2019/07/26/twitter-inc-twtr-q2-2019-earnings-call-transcript.aspx.

495. *Twitter*, 29 F.4th at 620.

496. *Id.* at 621. The court of appeals found other reasons for affirming dismissal insofar as the case rested on the July 2019 statements. The complaint failed to plead that the MAP software problems had “materialized and affected revenue” in that month. *Id.* The court of appeals read an August 6, 2019 tweet in which Twitter said it had “fixed” “issues” to refer to user privacy matters rather than software bugs. *Id.* The Ninth Circuit held that the July 2019 representations were forward-looking statements protected by the statutory safe harbor in 15 U.S.C. § 78u-5(c)(1)(A)(i) (2018). *Id.* at 623.

In one other case centering on the duty to disclose, the First Circuit affirmed dismissal of claims that a broker sold Puerto Rican securities to plaintiffs while failing to disclose (i) Puerto Rico’s troubled financial condition and (ii) the broker’s sale of the Puerto Rican securities it held for its own account. Ponsa-Rabell v. Santander Sec. LLC, 35 F.4th 26 (1st Cir. 2022).

497. 15 U.S.C. § 77z-2 (2018), with definitions at (i)(1)(A), (D); *id.* § 78u-5, with definitions at (i)(1)(A),(D).

498. *Id.* § 77z-2(c)(1); *id.* § 78u-5(c)(1).

499. Einhorn v. Axogen, Inc., 42 F.4th 1218, 1220 (11th Cir. 2022).

500. *Id.* at 1220 (class period); *id.* at 1221.

United States and Axogen's stock price declined,[501] investors sued under both Securities Act section 11 and Exchange Act section 10(b).[502]

Affirming district court dismissal,[503] two of the three Eleventh Circuit panel members held that the statements were statutorily protected forward-looking statements.[504] They read circuit authority to lean on "context" "[t]o differentiate 'historical observations,' which are not forward looking, from 'assumptions about future events,' which are forward looking," and to mean that "[e]ven a statement that depends in part on present-tense observations is due safe-harbor protection so long as the conclusion it supports is forward looking."[505]

The two judges found "the critical phrase in the challenged statements is Axogen's assertion that a certain number of peripheral nerve injuries and procedures occur in the United States 'each year.'"[506] While they could "imagine using the phrase 'each year' to refer solely to an existing or historical fact," they found that "as Axogen used the phrase, it is inherently forward looking; it was addressed to future years just as much as to past years or the present year."[507] The context tipped the balance decisively, for even "[t]he plaintiffs concede[d] that the statements were used to support Axogen's predictions about the size of the market that 'could be serviced' by its products," which amounted to "market-size predictions," which were "about 'future economic performance' and are defined as forward-looking statements under the statute."[508] While the plaintiffs argued that the challenged statements were a mix of separable forward-looking and historical parts, with the safe-harbor statutory provisions inapplicable to the latter, the panel majority responded that it could not "sever the meanings of" the single critical phrase, "each year."[509]

Applying, therefore, the safe harbor statute, the two judges noted that the plaintiffs could prevail only if they could plead and prove that an Axogen executive officer who approved the statements actually knew that they were false or misleading.[510] Since the plaintiff "d[id] not argue on appeal that it met the 'actual knowledge' standard," did not plead any facts to suggest such knowledge, and in fact "disclaimed any allegation that Axogen 'intentional[ly]' misrepresented anything," the statutory safe harbor required dismissal.[511]

501. *Id.* at 1221.
502. *Id.* at 1220.
503. *Id.* at 1225.
504. *Id.* at 1222–25.
505. *Id.* at 1223 (quoting Harris v. Ivax Corp., 182 F.3d 799, 805–06 (11th Cir. 1999)).
506. *Id.*
507. *Id.* at 1223–24.
508. *Id.* at 1224 (quoting 15 U.S.C. § 77z-2(i)(1)(C)).
509. *Id.*
510. *Id.*
511. *Id.* at 1224–25.

One judge on the panel concurred on the ground that the Axogen statements were opinions because the "[w]e believe" with which they led—coupled with "a nebulous term 'each year'"—"should have trigger[ed] the purchaser to realize that Axogen [was] reciting an opinion in the form of an estimate." *Id.* at 1228 (Lagoa, J., concurring). The complaint did not plead them false or misleading under any of three ways that *Omnicare* identified. *Id.* at 1225–31. First, the plaintiff did not claim that Axogen did not in fact believe the opinions. *Id.* at 1229. Second, the plaintiff could not claim

13. Merger Disclosures

Tribune Media Company ("Tribune") announced a merger with Sinclair Broadcasting Group ("Sinclair") in May 2017.[512] The agreement required Sinclair "to 'use reasonable best efforts' to satisfy demands of the Antitrust Division of the Department of Justice and the Federal Communications Commission ['FCC'], both of which had authority to block the merger or request the judiciary to stop it" (the "best efforts clause").[513] While the merger was under antitrust scrutiny, Oaktree Capital Management ("Oaktree") sold some of its Tribune stock through Morgan Stanley in a registered public offering.[514]

The Department of Justice wanted Sinclair to sell stations (at first ten, later reduced to eight) in markets where both it and Tribune operated.[515] After first refusing, Sinclair agreed after a Justice threat that it would sue to block the deal.[516] But the transactions Sinclair proposed to accomplish the divestitures would not, as Justice saw it, deprive Sinclair of control.[517] Fed up with Sinclair's aggressive tactics in the antitrust negotiations, Tribune terminated the merger in August 2018 and sued Sinclair for violating the "best efforts clause," eventually settling that action for $60 million.[518]

Investors sued Tribune and its directors under Securities Act section 11 and Rule 10b-5 and Morgan Stanley under Securities Act section 12(a)(2),[519] alleging that "[w]hen the previously concealed risk—that regulators would decline to grant approval, and the Merger would therefore fail—materialized, the price of Tribune stock declined dramatically, and Plaintiffs and other investors lost hundreds of millions of dollars."[520] In affirming dismissal,[521] the Seventh Circuit characterized the complaint as charging that the defendants "fail[ed] to disclose

that facts embedded in the opinions were false because, although the opinions cited three studies, those citations signified only that those studies existed and that Axogen reviewed them, and the plaintiff did not challenge either of those circumstances. *Id.* at 1229. Third, the plaintiff had not pled that Axogen omitted facts it knew that threw the three studies into question but only that those studies were "flawed" based on data and analyses that the plaintiff itself had assembled. *Id.* at 1231.

512. Water Island Event-Driven Fund, LLC v. Tribune Media Co., 39 F.4th 402, 404 (7th Cir. 2022).

513. *Id.*

514. *Id.*

515. *Id.* at 405.

516. *Id.*

517. *Id.*

518. *Id.* at 404–05. Tribune later sold itself to Nexstar Media Group in September 2019. *Id.* at 405.

519. The Seventh Circuit opinion provides a blurred description of the claims. The district court decision makes clear that the class—encompassing those who acquired Sinclair stock from November 29, 2017, through July 16, 2018—brought section 11 and Rule 10b-5 claims against Tribune and its directors, and a Securities Act section 12(a)(2) claim against Morgan Stanley. Arbitrage Event-Driven Fund, LLC v. Tribune Media Co., 18 C 6175, 2020 WL 60186, at *7, *14, *2 n.1 (N.D. Ill. Jan. 6, 2020). The plaintiffs also sued Oaktree for insider trading under Exchange Act section 20A. *Id.* at *11. The Seventh Circuit opinion does not address that 20A claim.

520. Amended Compl. at para. 50, Arbitrage Event-Driven Fund v. Tribune Media Co., No. 18-cv-06175 (CPK), 2020 WL 60186 (N.D. Ill. Jan. 6, 2020), 2019 WL 1442491.

521. *Tribune Media*, 39 F.4th at 408.

that Sinclair was playing hardball with the regulators, increasing the risk that the merger would be stymied."[522]

The court of appeals held that the Securities Act claims failed because "the Antitrust Division did not propose divestiture of eight to ten stations until November 17, 2017, and Sinclair did not reject that demand until December 15," which was "two weeks after plaintiffs say that they purchased shares from Morgan Stanley."[523] Since "[s]ecurities law requires honest disclosures but not prescience or mind reading," it was "impossible to rest any liability on the 1933 Act" for failure to disclose what had not yet occurred and what negotiating position Sinclair would take.[524]

Turning to the Rule 10b-5 claims, the panel held that "statements about prospects for the merger's success were forward-looking."[525] The Exchange Act shields such statements, with exceptions not applicable here, from private lawsuits if they 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]."[526] In this case, "[t]he press releases, proxy materials, and other statements issued in connection with the proposed merger, plus the quarterly reports filed before the merger was abandoned, all correctly stated the terms of the deal, including Sinclair's promise to use 'reasonable best efforts' to win approval."[527] Tribune added multiple cautions, which included: (i) the merger was "subject to a number of conditions, including conditions that may not be satisfied or completed on a timely basis, if at all"; (ii) there could be "no assurance that the actions Sinclair is required to take under the Merger Agreement to obtain the governmental approvals and consents necessary to complete the Merger will be sufficient to obtain such approvals and consents or that the divestitures contemplated by the Merger Agreement to obtain necessary governmental approvals and consents will be completed"; and (iii) "[f]ailure to obtain the necessary governmental approvals and consents would prevent the parties from consummating the proposed Merger."[528] All this constituted sufficient "cautionary" language to activate the Exchange Act safe harbor protection.[529]

Turning to scienter, the panel continued that, even "suppos[ing]" that Tribune concluded as early as December 2017 that Sinclair was "not doing enough" and that "the cautions about contingencies were no longer enough to meet the requirements of the safe harbor," "during the negotiations Sinclair assured Tribune that it would keep its promise, which makes it hard to say that Tribune acted with intent to defraud when it didn't disclose that Sinclair was balky."[530]

522. *Id.* at 405.
523. *Id.* at 406.
524. *Id.*
525. *Id.*
526. 15 U.S.C. § 78u-5(c)(1)(A) (2018).
527. *Tribune Media*, 39 F.4th at 406.
528. *Id.* at 406–07 (court's summary; not quotations from documents).
529. *Id.* at 407.
530. *Id.* ("There was at most a dispute, not certainty, about compliance ('reasonable' is a term hard to pin down)—and Tribune's executives were not privy to the thinking of Sinclair's executives.").

Moreover, the complaint did not say "when, if at all, Tribune learned about the 'entanglements' (the parties' word for the conditions on divestiture) that led to the merger's demise," thereby "mak[ing] it impossible to see how Tribune could have had fraudulent intent on the dates it made statements."[531]

14. Life Sciences

In 2022, three different circuit courts ruled in Rule 10b-5 cases that statements by life sciences issuers about clinical trials were not false or misleading. The Second Circuit affirmed dismissal where the plaintiffs alleged a drug manufacturer misrepresented the participants in a clinical trial by stating that they were limited to patients who "strongly" expressed a certain protein.[532] The Ninth Circuit affirmed dismissal where a pharmaceutical company announced a thirty-fold increase in cancer-fighting cells in ten patients in a Phase 1 trial but, in presenting results from a later Phase 1/2 trial, disclosed far less impressive results.[533] The First Circuit affirmed dismissal where a press release about clinical test results recounted the common adverse side effects in a clinical trial but did not separately discuss severe adverse effects.[534]

Description of patient population in trial. In 2009, Bristol-Myers Squibb Company ("Bristol-Myers") acquired the rights to develop a cancer drug called Opdivo.[535] On January 19, 2014, Bristol-Myers announced a clinical trial designed to determine whether Opdivo showed better results in patients with non-small cell lung cancer than chemotherapy.[536] The company thought that this might be true because Opdivo inhibited the interaction of two proteins in cancer cells that interfered with the immune system's ability to fight the cells.[537] The drug's efficacy in inhibiting that interaction, however, depended on the percentage of a patient's cancer cells having one of the proteins—PD-L1.[538] "[T]he higher the percentage of cancer cells with PD-L1, the 'stronger' the patient's PD-L1 'expression,' and the more effective the drug in treating that patient."[539]

In selecting the patients to participate in the clinical trial, Bristol-Myers had to balance the probability that the test would show efficacy (which would increase as the eligibility floor for PD-L1 expression increased) against the size of the potential market for the drug if efficacy were shown (which would increase as the eligibility floor for PD-L1 expression decreased).[540] Bristol-Myers decided that patients in the trial needed to meet only a 5 percent expression threshold.[541]

531. *Id.*
532. *See infra* notes 535–52 and accompanying text.
533. *See infra* notes 553–68 and accompanying text.
534. *See infra* notes 569–95 and accompanying text.
535. Ark. Pub. Emps. Ret. Sys. v. Bristol-Myers Squibb Co., 28 F.4th 343, 349 (2d Cir. 2022).
536. *Id.*
537. *Id.* at 347.
538. *Id.*
539. *Id.*
540. *Id.*
541. *Id.*

But the company did not disclose that threshold numerically when it announced the trial in January 2014, saying only "that the Opdivo trial would focus on results among patients 'strongly' expressing PD-L1."[542] In August 2016, Bristol-Myers announced that Opdivo had "failed to meet its primary goal—i.e., the drug did not show better results than chemotherapy in those 'strongly' expressing PD-L1" and that the company had defined "strong" expression as 5 percent or more.[543] Bristol-Myers's stock price declined, and investors filed a Rule 10b-5 action against the company and executives based primarily on the allegation that they misled the public by characterizing the clinical trial as restricted to patients whose cancer cells "strongly" expressed PD-L1.[544]

Affirming dismissal,[545] the Second Circuit determined the claims to rest on the allegation that the 5 percent threshold fell below an "industry consensus," that "strong" PD-L1 expression could not include 5 percent expression and that, indeed, "'strong' PD-L1 expression meant 50%."[546] But the court found that the complaint itself showed that "there was no general understanding of what constituted strong expression, and therefore no reason for the Investors to interpret 'strong expression' to mean any specific threshold—nor any reason why the description was false or misleading."[547] A "journal quoted in the Complaint observed in May 2016 that '[t]he best cut-off percentage . . . to determine PD-L1 positivity . . . remains an unresolved question.'"[548] And the complaint "detail[ed] varied thresholds used for PD-L1 positivity, ranging from 1% to 49%, depending on the study."[549] Moreover, while the Bristol-Myers trial was proceeding and before the company disclosed that it had employed the 5 percent threshold, "investment analysts at Alliance Bernstein and Goldman Sachs correctly predicted that Bristol-Myers defined strong expression as 5%."[550]

While Merck used the term "strong" PD-L1 expression in describing a successful clinical trial of its competing drug—a trial limited to patients with at least 50 percent expression—Merck announced its trial a few months after Bristol-Myers disclosed its Opdivo trial, and Merck did not reveal its 50 percent threshold for "strong" expression until February 2016, two years after Bristol-Myers announced its Opdivo trial.[551] Accordingly, Merck's "description of its study as

542. *Id.* at 349.

543. *Id.* To that point, Bristol-Myers had "made clear at all times that it would not disclose the exact threshold or confirm speculation or predictions." *Id.* at 353. But after Merck announced in February 2016 that—in a trial of a competing drug—it had "defined 'strong' expression as PD-L1 expression greater than 50%," Bristol-Myers did say that a strong expression was "'*lower than 50%*.'" *Id.* at 350, 354 (emphasis by the court).

544. *Id.* at 348 (stock price declined and action filed; complaint "allege[d] that the drop in stock price was attributable to the study's failure, and that Bristol-Myers had obscured the risk of such failure by declining to disclose the precise PD-L1 expression threshold and by misrepresenting that the study focused on patients 'strongly' expressing PD-L1"); *id.* at 351 (claims based on Rule 10b-5).

545. *Id.* at 348, 357.

546. *Id.* at 350.

547. *Id.* at 353.

548. *Id.* (alteration in original).

549. *Id.* at 354.

550. *Id.*

551. *Id.* at 348, 350, 354.

targeting strong expression, while using a 50% threshold, cannot reasonably be understood to bear upon Bristol-Myers's own internal definition of that term."[552]

Positive announcement based on a small sample in early trial results, followed by more modest results in later trial. The Ninth Circuit also found allegations against a life sciences company wanting last year because investors failed to adequately plead that a company's statements about a clinical trial were false. Nektar Therapeutics ("Nektar") developed a drug called NKTR-214 to stimulate the production of cancer-fighting cells.[553] Nektar conducted a Phase 1 clinical trial with the drug (the "EXCEL trial").[554] During that trial, the company prepared a chart that "show[ed] that cancer-fighting cells increased an average of about 30-fold among 10 patients after taking Nektar's drug" and "presented this 30-fold chart at many conferences."[555]

After the successful results from the EXCEL trial, Nektar conducted a second clinical trial of NKTR-214 (the Phase 1/2 "PIVOT trial") to determine the effect of using the drug with the Opdivo drug.[556] On June 2, 2018, Nektar released data from this trial that "showed that 'the overall response rate for NKTR-214 in treating melanoma had declined from the 85% rate presented the previous November to 50%.'"[557] Nektar's stock price dropped 42 percent on the next trading day.[558]

552. *Id.* at 354.

The complaint alleged that an expert oncologist would opine "that 'there was an industrywide consensus among all major participants in the immuno-oncology industry' that 5% expression meant 'low or minimal expression' and 50% expression was 'strong' expression." *Id.* at 351 (quoting complaint). However, that "opinion cannot rescue the Investors' claims, unless that opinion was based on particularized facts sufficient to state a claim for fraud. But the only facts on which [plaintiffs' expert] relied, according to the Complaint, are those already considered above and ruled insufficient." *Id.* at 354 (citing Joint App'x in turn citing the complaint).

The plaintiffs also attacked additional Bristol-Myers statements "variably describ[ing] the trial as 'the quickest way to bring Opdivo to first-line patients,' Compl. at para. 166, a study designed with 'great care,' *id.* at para. 193, or one in which Bristol-Myers had 'great confidence,' *id.* at para. 173." *Id.* But the court of appeals held that these statements were either protected forward-looking ones or opinions not alleged to be false under the rules governing that category of statements. *Id.* at 354–55.

The Second Circuit affirmed on the additional ground that the complaint failed to allege facts raising a strong inference of defendants' scienter. As to a possible motive for fraud, the plaintiffs charged that four of the six individual defendants sold Bristol-Myers stock during the class period, *id.* at 355, but those sales—in terms of the percentage of their stock in the company—were less than or only equal to the sales the defendants had made before the alleged fraud; and all but four of the individual defendants "bought more shares than they sold during the putative class period." *Id.* Moreover, "the vast majority of the sales were conducted pursuant to a 10b5-1 trading plan or were executed for procedural purposes, and therefore could not be timed suspiciously." *Id.* at 355–56 & n.4.

While acknowledging the "inescapable" conclusion that Bristol-Myers's 5 percent expression threshold "was set too low" in light of the successful Merck clinical study of its competing drug, the opinion concluded that this circumstance "provides no information regarding Bristol-Myers's state of mind when initially describing [its Opdivo] trial." *Id.* at 356. And the "departure of two high-level employees responsible for the [Opdivo] trial . . . may reflect the importance that Bristol-Myers placed on the study's potential success, but is no reason to doubt the veracity or intent of Bristol-Myers's disclosures." *Id.*

553. *In re* Nektar Therapeutics Sec. Litig., 34 F.4th 828, 832 (9th Cir. 2022).

554. *Id.*

555. *Id.* at 832–33.

556. *Id.* at 833.

557. *Id.*

558. *Id.*

Four months later, "anonymous short-sellers"—through what they called the Plainview Report—claimed that another Nektar chart (what the court called "Figure 6") showed that a single outlier patient who the Plainview Report claimed to have been one of the ten patients included in the thirty-fold chart had experienced an outsized increase in cancer-fighting cells while the other patients in Figure 6 showed more modest increases.[559] Nektar stock price then declined 7 percent.[560]

Two pension funds filed a Rule 10b-5 lawsuit against Nektar and individuals from that company, claiming that the thirty-fold chart was misleading because its presentation omitted to state that the average results included the outsized score from the outlier patient.[561] After the district court dismissed the case, the Ninth Circuit affirmed.[562] Noting the statutory requirement that, where the allegation that a statement was false is made on information and belief in a private action under the Exchange Act, "the complaint shall state with particularity all facts on which that belief is formed,"[563] the court of appeals found that the complaint here "does not allege with specificity what the Phase 1 EXCEL results would have been without outlier data."[564]

While the Plainview Report allegedly said "that the result 'would look very different' if one calculated the fold change based on only three patients found in Figure 6," "cherry-picking data from only three patients does not plausibly show the falsity of the 30-fold claim."[565] Though the complaint alleged that a confidential witness "contended that the results would have been 'nowhere near' the 30-fold result without [the outlier patient's] data, . . . it does not specify any further details."[566] And, while the plaintiffs also "rel[ied] on a statistical analysis by an expert who estimates, after making many assumptions, that the fold change experienced by the other patients in the 30-fold chart could not have topped 5.55," they "provided no plausible justification for the assumptions underlying how this expert precisely derived that 5.55-fold estimate."[567] Finally, the plaintiffs failed to show "whether a somewhat lower fold-change would have been material to investors," so that, for example, if "the number of cancer-fighting cells would have increased 15-fold . . . [p]erhaps investors would not care about such a difference if it turned out that a 30-fold increase

559. *Id.* at 833–34.
560. *Id.* at 834.
561. *Id.* at 832, 834.
562. *Id.* at 832, 840.
563. *Id.* at 835 (quoting 15 U.S.C. § 78u-4(b)(1)(B)).
564. *Id.* at 836.
565. *Id.* Comparisons were difficult in part because there had been twenty-eight patients in the EXCEL trial, only ten of whom were represented in the thirty-fold chart, *id.* at 836–37, with Figure 6 supposedly showing results for seven patients but the figure as it appears in the opinion only showing six, *id.* at 834, and the Plainview Report only relying on three of these (*id.* at 836). As the Ninth Circuit observed, "it is not even apparent from the complaint whether any patients from Figure 6 are in the 30-fold chart," *id.* at 836–37, although the Plainview Report claimed that the outlier patient was, *id.* at 834.
566. *Id.* at 837.
567. *Id.*

provides little marginal benefit over a 15-fold increase for most cancer patients."[568]

Omission of severe adverse effects from announcement of results including most common adverse effects. Karyopharm Therapeutics, Inc. ("Karyopharm") developed a drug called selinexor to treat cancer patients "suffering from relapsed or refractory multiple myeloma and acute myeloid leukemia"—i.e., suffering from cancer "which has not been eradicated despite treatment, or which has returned at least once following initially successful treatment."[569]

In a Phase 1 trial with patients who had received "at least three prior lines of treatment or therapy without success," the drug "evinced a substantial level of toxicity."[570] Among patients treated only with selinexor, only one in fifty-six showed "a 'partial response'—in other words, a decrease in the extent of the patient's cancer."[571] Among those treated with selinexor plus a steroid called dexamethasone, only 8.6 percent showed a partial response or full remission.[572]

Karyopharm initiated two Phase 2 trials. Begun in June 2014, the first terminated prematurely in March 2017 when the company announced that the trial would not show, with statistical significance, that selinexor alone was a superior treatment for acute myeloid leukemia.[573] That study, called SOPRA, "also evinced substantial toxicity: 100% of the patients treated with selinexor suffered from adverse events ('AEs') of varying degrees, including some which resulted in death."[574]

Before SOPRA concluded, Karyopharm began a second Phase 2 trial, called STORM.[575] On April 30, 2018, Karyopharm issued a press release "announcing top-line data from the second half of the STORM trial, which stated in relevant part that: 'Oral selinexor demonstrated a predictable and manageable tolerability profile, with safety results that were consistent with those previously reported from Part I of this study . . . and from other selinexor studies. As anticipated,

568. *Id.* at 837–38. Similarly, the plaintiffs claimed that Nektar falsely stated that patients received NKTR-214 every three weeks when, the plaintiffs charged, two of the patients in the group on which the thirty-fold increase was based received the drug every two weeks. "But the [plaintiffs] plead no facts suggesting why the one-week difference in dosing 'would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" *Id.* at 838 (quoting Levi v. Atossa Genetics, Inc. (*In re* Atossa Genetics Inc. Sec. Litig.), 868 F.3d 784, 795 (9th Cir. 2017) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988))). While "[i]t might be inferred that needing a higher frequency of dosing suggests a lower potency of the drug, . . . it is unclear how that relates to the viability of NKTR-214 on the market or, as a result, Nektar's attractiveness as an investment." *Id.*

As a second independent reason for affirming, the Ninth Circuit held that the complaint did "not plausibly establish loss causation." *Id.* at 838–40 (announcement of the PIVOT trial results was not a corrective disclosure because the alleged fraud involved results of the EXCEL trial and the two trials were different; the Plainview report was not a corrective disclosure because it was authored by short-sellers who explicitly disclaimed accuracy or completeness).

569. Thant v. Karyopharm Therapeutics Inc., 43 F.4th 214, 217 (1st Cir. 2022).

570. *Id.*

571. *Id.*

572. *Id.*

573. *Id.*

574. *Id.* at 217–18.

575. *Id.* at 218.

the most common [AEs] were nausea, vomiting, fatigue and reduced appetite and were primarily low grade and manageable with standard supportive care and/or dose modification.'"[576] On May 1, 2018, the Karyopharm CEO stated on a conference call "that '[t]he success of the STORM study is an important milestone for Karyopharm[, a]nd these data represent a significant step in establishing the efficacy and safety of selinexor as a new treatment option for patients with myeloma.'"[577]

On February 22, 2019, the FDA released a briefing document for a meeting of its Oncologic Drug Advisory Committee ("ODAC").[578] That report "highlighted three primary issues with the submitted study data: first, that the single-arm nature of the STORM trial [i.e., that it was conducted without a control group] could not provide conclusive data regarding the efficacy of selinexor; second, that the single-arm nature of the STORM trial could not provide conclusive data regarding the toxicity of selinexor; and finally, that while the STORM trial indicated that lower doses of selinexor were better-tolerated, it did not conclusively establish an optimal dose."[579] Karyopharm's stock price fell from "a closing price of $8.97 per share on February 21, 2019, to a closing price of $5.07 per share on February 22."[580] The stock price declined again when the ODAC voted to delay approval of selinexor until after a Phase 3 trial that Karyopharm had underway.[581]

Investors brought a putative class action against the company and officers alleging a Rule 10b-5 claim.[582] While the trial court had ruled that the complaint adequately alleged that the challenged statements were misleading but that the action should be dismissed because the plaintiffs did not plead sufficient particular facts to support a strong inference of scienter,[583] the First Circuit affirmed on the different ground that the plaintiffs had not "plausibly alleged" a material misstatement or omission.[584]

As to the April 30, 2018 press release, the plaintiffs alleged that it misled "because it omitted known information regarding the serious risks of selinexor treatment."[585] In particular, it failed to disclose that "'nearly 60% experienced a severe [AE], more than 25% of patients permanently discontinued the drug due to its side effects and approximately 18 on-study deaths were attributed to it.'"[586] In context, however, the STORM trial involved patients who suffered

576. *Id.* at 219.
577. *Id.* at 219–20.
578. *Id.* at 218.
579. *Id.*
580. *Id.* at 219.
581. *Id.*
582. *Id.* at 216.
583. *Id.* at 221.
584. *Id.* at 216, 226.
585. *Id.* at 219–20, 223.
586. *Id.* at 223–24. The plaintiff did "not claim that the information provided regarding the 'most common AEs' was itself materially misleading, nor [did] he claim that knowledge of additional common AEs would also have significantly altered the information available to investors." *Id.* at 224 (emphasis by the court).

from relapsed or treatment-resistant multiple myeloma, "a disease which Karyopharm explicitly acknowledged in public filings typically results in 'nearly all patients . . . eventually relaps[ing] and succumb[ing] to their disease.'"[587] Moreover, half of the STORM trial "specifically focused on treatment of 'heavily pretreated patients with penta-refractory myeloma'—i.e., patients whose cancer had continued to progress despite extensive and varied treatment and who were ultimately left with no other medical options."[588]

Perhaps more to the point, Karyopharm stated, "through Form 10-Ks issued both before and during the class period, that treatment with selinexor had resulted in 'serious' AEs in at least a 'small percentage' of patients. The 10-Ks filed in March of 2016, 2017, and 2018, each clarify that such serious AEs are those which 'result in death, are life threatening, require hospitalization or prolonging of hospitalization, or cause a significant and permanent disruption of normal life functions.'"[589] And the filings warned that "'as a result of these adverse events or further safety or toxicity issues . . . we may not receive approval to market any drug candidates,'" adding that the FDA "'may disagree with our clinical trial investigators' interpretation of data from clinical trials and the conclusion by us or our clinical trial investigators that a serious adverse effect or unacceptable side effect was not drug-related.'"[590]

Against this "background information, it is difficult to imagine that any investor would read the defendants' statements that Karyopharm had a 'predictable,' 'manageable,' and 'consistent' tolerability profile to indicate that selinexor was benign, or that the FDA would find it so."[591] Put in doctrinal terms, omission of the distribution of AEs and particularly the severe AEs in the press release on the STORM trial was not material because the market was already aware of the critical information—i.e., that selinexor could produce terrible side effects when used by the target population of extremely sick patients making their last stand against a fatal disease.[592]

Turning to the less troublesome May 1 conference call comments, the First Circuit found them to be "non-actionable puffery."[593] The CEO's "assertions that the results of the STORM study constitute 'an important milestone for Karyopharm' and represent 'a significant step in establishing the efficacy and safety of selinexor as a new treatment option for patients with myeloma,'" were "vague optimism about a product's future" that "cannot constitute a material misstatement for purposes of the pleading requirements set by" statute.[594]

Significance and analysis. Another court might have reached a different conclusion as to the materiality of information about the severe AEs among STORM

587. *Id.* at 224 (alteration by the court).
588. *Id.*
589. *Id.*
590. *Id.* (alteration by the court).
591. *Id.* at 225.
592. *Id.*
593. *Id.* at 223.
594. *Id.* (referring apparently to 15 U.S.C. § 78u-4(b)(1)).

study participants. It might have ruled that, particularly in light of the drug's previous record of toxicity and the vulnerable population at which it was aimed, investors would have been keen to know that almost 60 percent of the study patients experienced severe AEs during the trial. Finding as a matter of law on pled and judicially recognizable facts that information about side effects is not material is a tricky business in light of *Matrixx Initiatives, Inc. v. Siracusano*, where the Court held that such information could be material even if it does not rise to the level of statistical significance.[595]

15. Criminal Cases

The jury in *Unites States v. Armbruster* convicted the named defendant on four of eleven counts and acquitted two codefendants.[596] Armbruster had served as the Roadrunner Transportation Systems, Inc. ("Roadrunner") CFO.[597] His convictions revolved around two balance sheet items on the books of Morgan Southern, a subsidiary that Roadrunner acquired: (i) an account receivable from IKEA Maersk carried at above its realizable value and (ii) "prepaid" taxes recorded as such even though the amounts were already due and owing.[598] Armbruster was convicted on two counts of knowingly falsifying the Roadrunner accounting records (into which the Morgan Southern numbers were consolidated)[599] in violation of Exchange Act section 13(b)(2) and (5); one count of submitting a false representation letter to Roadrunner's outside auditor relating to Roadrunner's third-quarter 2016 numbers and thereby misleading the outside accountant in violation of Rule 13b2-2(b); and one count of violating 18 U.S.C. § 1348 by submitting false financial numbers to the SEC for that quarter.[600] The counts also involved 18 U.S.C. § 2, which provides for aiding and abetting liability so that Armbruster would have been liable even if he did not himself commit the substantive violation but aided and abetted another—e.g., the company—in that other's substantive violation.[601] On appeal, the Seventh Circuit affirmed the convictions against Armbruster's challenge to the sufficiency of the evidence

595. 563 U.S. 27, 39–42 (2011).
596. United States v. Armbruster, 48 F.4th 527, 531 (7th Cir. 2022).
597. *Id.* at 529.
598. *Id.* at 530.
599. *Id.* at 531.
600. *Id.* SEC Rule 13(b)(2) prohibits any officer or director of a public company from "directly or indirectly tak[ing] any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission" if the officer or director "knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading." 17 C.F.R. § 240.13b2-2(b)(1) (2022); *Armbruster*, 48 F.4th at 534. Exchange Act section 32(a) makes it a crime to willfully violate that, or any other rule under the Exchange Act. 15 U.S.C. § 78ff(a) (2018). The trial court explicitly charged the jury on the elements of Rule 13b2-2(b). *Armbruster*, 48 F.4th at 534.
601. *Armbruster*, 48 F.4th at 531.

at trial, employing the standard that required affirmance unless "'no rational trier of fact could have found the defendant guilty.'"[602]

The trial evidence included the following: A May 2014 email from a Roadrunner financial analyst to several accountants, including Armbruster, attached a spreadsheet containing "the notation 'probably a full write off' next to the IKEA Maersk receivable line item."[603] A former Morgan Southern controller (who departed in April 2016) "told the jury that he informed Armbruster of the results of his assessment of Morgan Southern's accounting practices, including its overstatement of the collectability of the IKEA Maersk receivable and inflation of the prepaid taxes account."[604] He also "walked the jury through Roadrunner's plan to write off the uncollectable and overstated account balances over time, describing email threads with Armbruster that discussed the need to record material adjustments to both accounts."[605] When that controller's successor "promptly noticed the company's accounting problems, including the overstatement of the IKEA Maersk receivable and prepaid taxes account" and "relayed his concerns . . . to Roadrunner's vice president of finance,"[606] that finance VP "provided Armbruster with the results" of this analysis, including those relating to the receivable and the prepaid taxes.[607] At a November 2016 meeting "shortly before Armbruster submitted a letter to Deloitte representing that he had no knowledge of material misstatements or irregularities in Roadrunner's financial accounting and reporting," Roadrunner's executive vice president "listed on a whiteboard the many accounting challenges the company faced, including those with respect to Morgan Southern accounts receivable and prepaid taxes," "emphasiz[ing] the need to make adjustments to allow the company to report both account balances in accordance with [Generally Accepted Accounting Principles]."[608] Armbruster attended that meeting.[609] The audit partner for Roadrunner's outside accountant testified that "he was alarmed to learn about the whiteboard meeting and related email correspondence."[610]

This evidence was sufficient to convict on the two counts for falsifying books and records because "the jury could—and did—reasonably find that Armbruster knowingly and willfully allowed the Morgan Southern IKEA Maersk receivable and prepaid taxes account to remain overstated in the company's accounting records and, in turn, in Roadrunner's consolidated balance sheet during the relevant

602. *Id.* at 529, 531 (quoting United States v. Johnson, 874 F.3d 990, 998 (7th Cir. 2017) (cleaned up)); *id.* at 536.

603. *Id.* at 533.

604. *Id.* at 530 (identifying controller and stating when he left); *id.* at 532.

605. *Id.* at 532.

606. *Id.* at 530.

607. *Id.* at 532.

608. *Id.* Someone at the meeting took a photo of the whiteboard, and the government presented that photo at the trial. *Id.*

609. *Id.* at 534–35. The Seventh Circuit described additional evidence, including that the Morgan Southern accounting was in disarray when Roadrunner purchased that company. *Id.* at 529.

610. *Id.* at 535.

periods."[611] It was sufficient to convict on the 18 U.S.C. § 1348 securities fraud count because "[t]he jury had enough to conclude that Armbruster knowingly allowed the company's 3Q-2016 financial statements to include material misstatements by leaving the Morgan Southern IKEA Maersk and prepaid tax accounts overstated, as reflected in Roadrunner's consolidated financial statements."[612] It sufficed for conviction on the representation letter to the outside auditor because it "allowed the jury to infer that Armbruster understood his responsibility to communicate honestly with auditors and that he knowingly shirked his duty by signing a management representation letter that failed to notify Deloitte of the clear concerns many within Roadrunner held about the two accounts in question."[613]

Significance and analysis. Exchange Act section 13(b)(5) provides that "[n]o person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account" of an issuer with securities registered under section 12 of that act or required to file reports under section 15.[614] The Seventh Circuit affirmed conviction on two violations of this statute because the evidence permitted the conclusion that Armbruster "knowingly and willfully allowed" the two accounts at the subsidiary "to remain overstated" in the subsidiary's accounting numbers, which were consolidated into the public company financials.[615] His conviction reminds us that a CFO can run afoul of section 13(b)(5) even if the false numbers are inside a subsidiary's financial statement that is consolidated into the public company's reports and even if the CFO does not himself or herself keystroke the false numbers into either the subsidiary or public company balance sheet, income statement, or cash flow report.

The conviction also emphasizes, from a counseling point of view, that a CFO who did not himself or herself initiate a fraud can risk criminal liability if that CFO fails to affirmatively address an accounting problem that is brought to his or her attention, with the risk that the government might institute a prosecution and that the CFO might suffer a conviction both mounting with the number of different finance and accounting professionals bringing the problem to the CFO's attention and the number of accounting periods during which the CFO delays a response.[616]

611. *Id.* at 533.

612. *Id.* at 534.

613. *Id.* at 535.

614. 15 U.S.C. § 78m(b)(5) (2018) (subsection (b)(4) permitting criminal liability for a violation of (b)(5)).

615. *Armbruster*, 48 F.4th at 533.

616. *Id.* (the court referring to "the corroboration from various sources of evidence, from the multiple witnesses at different levels of Roadrunner's accounting and finance department to the documents spanning several years").

In one other criminal case, the Seventh Circuit affirmed the criminal conviction of a remote tippee, holding that the indictment satisfactorily pled the element that the initial tipper received a personal benefit by alleging that the initial tippee was a close personal friend of the tipper. United States v. Weller, 40 F.4th 563, 566 (7th Cir. 2022), *cert. denied*, 143 S. Ct. 427 (2022) (mem.).

16. Miscellaneous

The Fifth Circuit affirmed a bench trial judgment for the Commission and against brokers on alleged violations of multiple securities laws based on cherry-picking from block trades to allocate profitable transactions to favored accounts and unprofitable ones to disfavored accounts.[617] The Ninth Circuit held that SEC Rule 16b-3(d)(1)'s exemption from Exchange Act section 16(b) short-swing profit recovery—for acquisitions from the issuer approved by the board of directors—does not require that the acquisition be unanimously approved by a board of directors but is satisfied if the board approval complies with state corporate law, in this case at a meeting attended by four of the five directors and a vote by three of them to approve (the fourth being the officer receiving the options/warrants grant, who did not vote on the matter).[618] The Eleventh Circuit affirmed dismissal of a state fiduciary law class action against an investment adviser who urged customers to invest tax-qualified retirement accounts in variable annuities, holding the gravamen of the claim to consist of misrepresentations and omissions regarding suitability of the investments and that the Securities Litigation Uniform Standards Act therefore barred the lawsuit.[619]

617. SEC v. World Tree Fin., L.L.C., 43 F.4th 448 (5th Cir. 2022).

618. Alpha Venture Cap. Partners LP v. Pourhassan, 30 F.4th 920 (9th Cir. 2022).

619. Cochran v. Penn Mutual Life Ins. Co., 35 F.4th 1310 (11th Cir. 2022), *cert. denied*, 143 S. Ct. 782 (2023).