

Clients & Friends Memo

2017 Year in Review: Securities Litigation and Regulation

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The securities litigation and regulatory landscape in 2017 defies simple categorization. Plaintiffs filed 226 new federal class actions in the first half of 2017, more than double the average rate over the last 20 years,¹ and an additional 99 federal class actions in the third quarter of 2017.² In contrast, new SEC enforcement proceedings declined. After staying on pace with the prior two years with 45 new enforcement actions against public company-related defendants in the first half of fiscal year 2017, the SEC filed only 17 new enforcement actions against public company-related defendants in the second half of the year.³ The apparent decrease in initiation of enforcement proceedings coincides with the arrival at the SEC of Chairman Walter J. Clayton, who has expressed the view that enforcement actions against issuers rather than individual wrongdoers too often punish the very investors they seek to protect.⁴

Amidst this activity, there were a number of important legal and regulatory developments, including in the following areas:

- **Statutes of Limitations and Repose:** The Supreme Court held that the SEC's disgorgement remedy is subject to a five-year statute of limitations, and that a pending class action does not toll the three-year statute of repose under the Securities Act of 1933 (the "Securities Act") for opt-out plaintiffs.

¹ Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse, Securities Class Action Filings: 2017 Midyear Assessment, <https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2017-Midyear-Assessment>.

² Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse, Securities Class Action Filings: 2017 Q3, <https://www.cornerstone.com/Publications/Research/Securities-Class-Action-Filings-2017-Q3>.

³ Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse, SEC Enforcement Activity: Public Companies and Subsidiaries, <https://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-2017-Update>.

⁴ See Hearing Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Nomination of Jay Clayton, S. Hrg. 115-9 (Mar. 23, 2017) ("There should be deterrence at the company level [but] shareholders do bear those costs I firmly believe that individual accountability drives behavior more than corporate accountability.").

- **Class Actions:** The Second Circuit held that questions regarding whether activity in the U.S. warrants application of the federal securities laws under *Morrison* may constitute individual issues that defeat the “predominance” requirement for class certification. The Second Circuit also approved the use of indirect evidence of market efficiency in evaluating whether the fraud-on-the-market presumption applies for purposes of certifying a class action asserting a claim under Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”). The Supreme Court granted certiorari in a case that will require it to decide whether state courts retain concurrent jurisdiction over securities claims covered by the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”).
- **Securities Fraud:** The Second Circuit confirmed the operative test to determine the materiality of an omission of interim financial information, and also held that national securities exchanges may face liability in private securities litigation. The Ninth Circuit extended the *Omnicare* test for determining when statements of opinion are actionable to Section 10(b) claims. The United States District Court for the District of Utah held that, in actions brought by the SEC, Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act should be applied to extraterritorial transactions to the extent that the “conduct and effects” test can be satisfied.
- **Insider Trading:** Following the Supreme Court’s decision in *Salman v. United States*, the Second Circuit held that a gift of insider information may be illegal even if the tipper lacks a meaningfully close relationship with the tippee.
- **Indemnification:** The United States District Court for the Southern District of New York held that public policy prohibits an underwriter from seeking contractual indemnification of settlement costs from an issuer unless the underwriter has demonstrated that it was without fault.
- **Whistleblower Actions:** The Supreme Court granted certiorari to consider whether whistleblowers who report securities law violations to their internal managers, not to the SEC, are entitled to utilize the anti-retaliation protections in the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).
- **Securities Regulation and Enforcement:** The SEC determined that certain applications of distributed ledger or blockchain technology, such as bitcoin and similar “coins,” can be securities subject to regulation under the federal securities laws. The new leadership focused the SEC’s enforcement priorities on cybersecurity, protecting retail investors, and pursuing individual violators, and attempted to cure doubts about the authority of its Administrative Law Judges. The House of Representatives passed the Financial CHOICE Act, which would require changes to many aspects of SEC enforcement practices.

I. Statutes of Limitations and Repose

A. SEC Disgorgement Remedy Subject to Five-Year Statute of Limitations

In *Kokesh v. SEC*,⁵ the Supreme Court held that the SEC's ability to seek disgorgement as a remedy in an enforcement action is subject to a five-year statute of limitations under 28 U.S.C. § 2462, which provides that "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued."⁶ In 2009, the SEC brought an enforcement action against Charles Kokesh in the United States District Court for the District of New Mexico, alleging that Kokesh misappropriated \$34.9 million from two investment firms that he operated. Following a jury verdict in favor of the SEC, the District Court entered a permanent injunction enjoining Kokesh from violating certain provisions of the federal securities laws, imposed a civil penalty, and ordered disgorgement of profits. Although the District Court limited recovery of the civil penalty to funds Kokesh received within five years of the SEC's filing of its complaint, the Court ordered full disgorgement of \$34.9 million in ill-gotten gains, holding that the five-year statute of limitations under 28 U.S.C. § 2462 does not apply to disgorgement because it is not a "civil fine, penalty, or forfeiture."⁷ The Tenth Circuit affirmed the District Court's judgment with respect to disgorgement.

The Supreme Court reversed in an unanimous decision, holding that disgorgement is a "penalty" under 28 U.S.C. § 462. The Court explained that the purpose of disgorgement, to deter future violations by requiring the forfeiture of profits from securities violations, is "inherently punitive."⁸ The remedy is not compensatory in nature because, when it seeks disgorgement, the SEC does so on behalf of the public at large, rather than on behalf of "an aggrieved individual,"⁹ and profits are paid to the district court, "not to victims."¹⁰ Thus, the Court ruled that the SEC may not seek disgorgement for misappropriation that occurred more than five years before the SEC filed its complaint.¹¹

Kokesh further limits the remedies available to the SEC outside the five-year limitations period set forth in 28 U.S.C. § 462, which the Supreme Court previously held applies to statutory monetary

⁵ 137 S. Ct. 1635, 1638-44.

⁶ 28 U.S.C. § 2462

⁷ 137 S. Ct. at 1643-44.

⁸ *Id.* at 1641.

⁹ *Id.* at 1643.

¹⁰ *Id.* at 1644.

¹¹ *Id.*

penalties.¹² *Kokesh* likely will have several important effects in SEC enforcement actions, including potentially reducing the SEC's leverage in settlement negotiations, limiting investigations involving older conduct, and motivating the SEC to seek tolling agreements to extend the limitations period as much as possible. Steve Peikin, Co-Director of the Division of Enforcement, remarked that, in light of *Kokesh*, the SEC "[has] no choice but to respond by redoubling our efforts to bring cases as quickly as possible."¹³ The SEC also may attempt to seek remedies other than disgorgement in order to avoid the potential preclusive effect of the five-year limitations period. For example, post-*Kokesh*, the Eighth Circuit held that a permanent injunction enjoining the defendant from future violations of the securities laws was not a "penalty" under 28 U.S.C. § 462 because "[t]he historic injunctive process was designed to deter, not to punish."¹⁴

B. Statute of Repose Not Tolled Under *American Pipe*

In *California Public Employees Retirement System v. ANZ Securities, Inc.*,¹⁵ the Supreme Court held that the *American Pipe* doctrine does not toll the three-year statute of repose under Section 13 of the Securities Act.

In 2008, investors brought a putative class action asserting claims under Section 11 of the Securities Act against Lehman Brothers Holdings Inc. in the United States District Court for the Southern District of New York. The plaintiffs alleged that the Lehman Brothers' registration statement for certain securities offerings contained material misstatements and omissions. California Public Employees Retirement System ("CalPERS") opted out of a subsequent class settlement and in 2011 filed an individual action against Lehman Brothers in the Northern District of California. Lehman Brothers moved to dismiss the individual action, arguing that the claims were untimely under the three-year statute of repose since the registration statements containing the alleged misstatements were filed in 2007 and 2008. CalPERS countered that the three-year time bar was tolled under *American Pipe*, in which the Supreme Court ruled that the statute of limitations for individual claims of absent class members may be tolled on equitable grounds while a timely-filed class action is pending.¹⁶ The District Court rejected the tolling argument and dismissed CalPERS' individual action as untimely. The Second Circuit affirmed.

The Supreme Court granted certiorari and affirmed. The Supreme Court distinguished *American Pipe*, explaining that the equitable justifications for tolling a statute of limitations are not applicable to statutes of repose such as Section 13. Unlike a statute of limitations, which "[is] designed to

¹² See *Gabelli v. SEC*, 568 U.S. 442, 454 (2013).

¹³ Steven R. Peikin, Co-Director, Enforcement Division, "Reflections on the Past, Present, and Future of the SEC's Enforcement of Foreign Corrupt Practices Act," <https://www.sec.gov/news/speech/speech-peikin-2017-11-09>.

¹⁴ *SEC v. Collyard*, 861 F.3d 760, 764 (8th Cir. 2017) (citation omitted).

¹⁵ 137 S. Ct. 2042, 2049-55 (2017).

¹⁶ *American Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 556 (1974).

encourage plaintiffs to pursue diligent prosecution of known claims,"¹⁷ the "object of a statute of repose, to grant complete peace to defendants, supersedes the application of a tolling rule based in equity."¹⁸ "[T]he text, purpose, structure, and history of [Section 13] all disclose the congressional purpose to offer defendants full and final security after three years."¹⁹ As a statute of repose, Section 13 "displaces the traditional power of courts to modify statutory time limits in the name of equity."²⁰

ANZ should incentivize larger stockholders to file individual actions under Section 11 relatively soon after a class action complaint is filed. The impact of ANZ may be limited, however, given that several circuits (including the Second Circuit, Sixth Circuit, and Eleventh Circuit) previously had held that the three-year statute of repose is not tolled under *American Pipe*.²¹ For average investors, moreover, the costs of filing individual actions will continue to far outweigh the benefits, muting concerns that ANZ will open the "floodgates" to individual securities fraud actions.

II. Class Actions

A. Second Circuit Holds That Individualized *Morrison* Questions May Defeat Class Certification

In *In re Petrobras Securities Litigation*,²² the Second Circuit revisited the "predominance" requirement for certifying a securities class action under Federal Rule of Civil Procedure 23(b)(3).

Petrobras arose out of an alleged money-laundering and kick-back scheme by Petróleo Brasileiro S.A. ("Petrobras"), a multinational oil and gas company headquartered in Brazil. After the scheme was revealed, investors brought claims against Petrobras and its officers and directors under both the Securities Act and the Exchange Act. Judge Jed Rakoff of the Southern District of New York granted class certification, and Petrobras appealed, arguing that individual questions predominated as to whether class members purchased Petrobras stock in U.S. transactions or on foreign exchanges, constituting foreign transactions not covered by the federal securities laws under *Morrison v. National Australia Bank*.²³

¹⁷ 137 S. Ct. at 2049.

¹⁸ *Id.* at 2052.

¹⁹ *Id.*

²⁰ *Id.* at 2055.

²¹ See *Police & Fire Ret. Sys. of City of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013); *Stein v. Regions Morgan Keegan Select High Income Fund, Inc.*, 821 F.3d 780 (6th Cir. 2016); *Dusek v. JPMorgan Chase & Co.*, 832 F.3d 1243, 1249 (11th Cir. 2016).

²² 862 F.3d 250, 273-78 (2d Cir. 2017).

²³ 561 U.S. 247 (2010).

The Second Circuit reversed and remanded for further factual findings on whether common questions predominated. The Second Circuit explained that, when a district court considers whether individual issues relevant to determining whether the federal securities law apply under *Morrison* predominate, it must determine whether the question of domesticity (*i.e.*, whether the securities transactions at issue had a sufficient connection to the United States) is “susceptible to generalized class-wide proof” such that it represents a ‘common’ question rather than an ‘individual’ one.”²⁴ In this case, the Second Circuit could not conclude that common questions predominated over individual questions given the numerous domestic and foreign entity purchasers and varying methods of purchasing Petrobras securities.²⁵ The Second Circuit expressed skepticism that the domesticity question was susceptible to class-wide proof because the class included secondary-market purchasers that would have to trace their purchases to a domestic market. That inquiry would require different proof than for primary market purchasers. “In this case, the potential for variation across putative class members—who sold them the relevant securities, how those transactions were effectuated, and what forms of documentation might be offered in support of domesticity—appears to generate a set of individualized inquiries that must be considered within the framework of Rule 23(b)(3)’s predominance requirement.”²⁶

A petition for certiorari seeking review of the Second Circuit’s decision is pending before the Supreme Court.²⁷ If the decision stands, it would complicate the ability of securities plaintiffs to achieve certification of putative classes that include both U.S. and non-U.S. purchasers. But it would not foreclose the possibility of certifying such classes. The Second Circuit suggested that district courts may in effect circumvent certification challenges under *Morrison* by utilizing case management techniques, including bifurcating proceedings “to hone in on threshold class-wide inquiries.”²⁸ In addition, despite a challenge under *Petrobras*, the United States District Court for the Southern District of Texas recently certified a class that “could conceivably” include members that engaged in foreign transactions, noting “the ease of determining whether that was the case.”²⁹

B. Second Circuit Considers Sufficiency of Indirect Evidence for Establishing Fraud-On-The-Market Presumption

In *Basic v. Levinson*,³⁰ the Supreme Court explained that market efficiency is essential to certification of class actions asserting Section 10(b) claims because such claims require a showing

²⁴ *Petrobras*, 862 F.3d 250 at 271 (quoting *Tyson Foods, Inc. v. Bouaphakeo*, 136 S. Ct. 1036, 1045 (2016)).

²⁵ *Id.* at 271-73.

²⁶ *Id.* at 273.

²⁷ *Petroleo Brasileiro S.A. v. Universities Superannuation Scheme Ltd.*, No. 17-664 (U.S.).

²⁸ *Petrobras*, 862 F.3d at 274.

²⁹ *In re Cobalt Int’l Energy, Inc. Sec. Litig.*, 2017 WL 3620590, at *3 (S.D. Tex. Aug. 23, 2017).

³⁰ 485 U.S. 224, 247 (1988).

that plaintiffs relied on the alleged misrepresentation. Although this ordinarily would require a highly fact-specific individual assessment, a court may presume that all investors rely on the integrity of the market price of a security as reflecting all public information, including any fraudulent statements, when a stock trades in an efficient market.³¹ This “fraud-on-the-market” theory allows class action plaintiffs to utilize a presumption of reliance, eliminating the need for individual inquiries in connection with class certification. Absent availability of a fraud-on-the-market presumption, it would be virtually impossible for plaintiffs to maintain Section 10(b) class actions.³²

In connection with their appeal of Judge Rakoff’s class certification order (described in the preceding section), the *Petrobras* defendants argued that the fraud-on-the-market presumption was unavailing because plaintiffs failed to show that “the defendant’s stock tends to respond to pertinent publicly reported events.”³³ The Second Circuit disagreed, explaining that Judge Rakoff’s “blended consideration of direct and indirect evidence of market efficiency” was an appropriate basis for applying the fraud-on-the-market presumption.³⁴ The Second Circuit explained that, to determine whether a stock trades in an efficient market, courts may consider both indirect evidence, including “high trading volume, extensive analyst coverage, multiple market makers, large market capitalization, and an issuer’s eligibility for simplified SEC filings,” and direct evidence, including “empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price.”³⁵ The Court also rejected defendants’ argument that plaintiffs must show “market efficiency based on directional empirical evidence alone, irrespective of any other evidence they may have offered.”³⁶ This theory would “relabel a sufficient condition as a necessary one,” and neglect that “indirect evidence is particularly valuable in situations where direct evidence does not entirely resolve the question.”³⁷

Only three years ago, many commentators and practitioners were predicting the demise of the fraud-on-the-market presumption of reliance when the Supreme Court granted certiorari in a case challenging the continued viability of this theory. But, in *Halliburton Company v. Erica P. John Fund, Inc. (Halliburton II)*,³⁸ the Supreme Court declined to abrogate the fraud-on-the-market theory. *Petrobras* confirms that it remains alive and well. Securities class action defendants can take some comfort in the Supreme Court’s recent class action jurisprudence holding, among other things, that

³¹ *Id.* at 255-257.

³² *Id.*

³³ *Petrobras*, 862 F.3d 250 at 276.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at 277-278.

³⁷ *Id.* at 278.

³⁸ 134 S. Ct. 2398, 2417 (2014).

all the prerequisites to class certification must be proven at the class certification stage (even if those requirements overlap with merits determinations) and permitting defendants to introduce and requiring courts to consider evidence at the class certification stage to rebut the presumption of reliance.³⁹ Nonetheless, it remains challenging to defeat the presumption in Section 10(b) class actions.⁴⁰

C. Supreme Court to Decide Whether State Courts Have Subject Matter Jurisdiction Over Class Actions That Allege Only Securities Act Claims

The Supreme Court will decide whether state courts retain concurrent jurisdiction to hear Securities Act class actions. On November 28, the Supreme Court heard oral argument in *Cyan Inc. et al. v. Beaver County Employees' Retirement Fund*. The dispute focuses on interpretation of the “conforming amendment” to the Securities Act that Congress passed as part of SLUSA. The statute provides that state courts continue to have concurrent jurisdiction over claims under the Securities Act except with respect to “covered class actions.” A “covered class action” is defined as “any single lawsuit in which . . . damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members.”⁴¹

In *Cyan*, the appellant has taken the position that “covered class actions” includes only actions based solely on claims arising under the Securities Act. In contrast, the appellee argues that SLUSA “strips state courts of jurisdiction over mixed cases,” in which a plaintiff advances a claim under the Securities Act along with “a prohibited state law claim.”⁴² The federal district courts are split on the question: the dominant view around the country is that state courts have subject matter jurisdiction over covered class actions that allege only Securities Act claims, while a growing consensus within the Second Circuit is that they do not.⁴³ A ruling in favor of the appellant likely

³⁹ See *Wal-Mart Stores, Inc. v. Dukes*, 564 U.S. 338, 351-53 (2011); *Comcast Corp. v. Behrend*, 133 S. Ct. 1426, 1432-35 (2013).

⁴⁰ In the aftermath of *Wal-Mart*, *Comcast*, and *Halliburton II*, district courts have routinely certified investor classes under a fraud-on-the-market theory of reliance. See e.g., *Ludlow v. BP, P.L.C.*, 800 F.3d 674, 683-89 (5th Cir. 2015); *Howard v. Liquidity Servs. Inc.*, 2017 WL 3948454, at *8-31 (D.D.C. Sept. 6, 2017); *Strougo v. Barclays PLC*, 312 F.R.D. 307, 328-29 (S.D.N.Y. 2016); *Carpenters Pension Trust Fund of St. Louis v. Barclays PLC*, 310 F.R.D. 69, 94-99 (S.D.N.Y. 2015); *In re Bridgepoint Educ., Inc. Sec. Litig.*, 2015 WL 224631, at *4-8 (S.D. Cal. Jan. 15, 2015).

⁴¹ 15 U.S.C. § 78bb(f)(5)(B)(i)

⁴² Brief for Respondents, *Cyan, Inc. v. Beaver County Employees Ret. Fund*, No. 15-1439, 2017 WL 4602252, at *5 (U.S. Oct. 13, 2017).

⁴³ See e.g., *Schwartz v. Concordia Int'l Corp.*, 255 F. Supp. 3d 380, 386 (E.D.N.Y. 2017) (collecting cases); *Rajasekaran v. CytRx Corp.*, 2014 WL 4330787, at *5-8 (C.D. Cal. Aug. 21, 2014).

would bring an end to state court Securities Act class actions, which have exploded in California, for instance, by 1,400 percent since 2011.⁴⁴

III. Securities Fraud

A. Ninth Circuit Extends *Omnicare's* Pleading Requirements for Statements of Opinion to Section 10(b) Claims

In 2015, the Supreme Court issued its decision *Omnicare v. Laborers District Council Construction Industry Fund*,⁴⁵ holding that, in order to plead a Section 11 claim based on an allegedly false or misleading statement of opinion, a plaintiff must allege not only that the statement was actually false but that the defendant subjectively did not believe the statement in question: “[A] sincere statement of pure opinion is not an untrue statement of material fact, regardless whether an investor can ultimately prove the belief wrong.”⁴⁶ Nonetheless, if a “registration statement omits material facts about the issuer’s inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11’s omissions clause creates liability.”⁴⁷

In *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology, Inc.*,⁴⁸ the Ninth Circuit extended *Omnicare* to Section 10(b) claims. The dispute arose out of Align Technology, Inc.’s acquisition of Cadent Holdings, Inc. Align acquired Cadent for \$187.6 million, announcing at the time that \$76.9 million of the value was goodwill associated with certain Cadent business units. Those business units went on to underperform Align’s growth projections, and Align eventually wrote down the goodwill to zero. Plaintiffs commenced a putative class action asserting that Align violated Section 10(b) on the ground that it knew Cadent had artificially inflated goodwill at the time of the acquisition. The United States District Court for the Central District of California dismissed the action on the basis that the plaintiffs failed to allege that Align subjectively believed that the goodwill valuations, which the Court deemed to be classic opinion statements, were false.⁴⁹

⁴⁴ Petition for Writ of Certiorari, *Cyan, Inc. v. Beaver County Emps.’ Ret. Fund*, No. 15-1439, 2016 WL 3040512, at *2 (U.S. May 24, 2016).

⁴⁵ 135 S. Ct. 1318, 1323-29 (2015).

⁴⁶ *Id.* at 1327.

⁴⁷ *Id.*

⁴⁸ 856 F.3d 605, 616 (9th Cir. 2017).

⁴⁹ *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc.*, 2013 WL 6441843, at *6 (N.D. Cal. Dec. 9, 2013).

In affirming, the Ninth Circuit held that the complaint was required to contain “allegations of subjective falsity.”⁵⁰ The plaintiffs argued on appeal that they were not required to plead that Align subjectively believed that its goodwill valuations were false, but rather that there was no reasonable basis for the belief. The Ninth Circuit rejected that argument, extending *Omnicare* to Section 10(b) claims because “Section 10(b)[] contains an identical limitation of liability to untrue statement[s] and omissions of fact.”⁵¹ The Court explained that *Omnicare* created different standards for pleading a misrepresentation or material omission based on a statement of opinion. Under the standards applicable to misrepresentations and materially misleading opinion statements, a plaintiff must plead both objective and subjective falsity.⁵² But under the standard applicable to omissions, a plaintiff must plead “facts going to the basis for the issuer’s opinion . . . whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context.”⁵³ Because the plaintiffs failed to allege omissions that “call[ed] into question the issuer’s basis for offering the opinion,” the plaintiffs’ failure to allege subjective falsity was fatal to their claims.⁵⁴

In *Align*, the Ninth Circuit joined the Second Circuit in extending *Omnicare*’s pleading standard for statements of opinion to Section 10(b) claims.⁵⁵ These decisions should reduce the risk that issuers and management will face antifraud liability for honest, subjectively held statements of opinion. They do not eliminate the risk, however, since plaintiffs may attempt to compensate by relying more heavily on an “omissions” theory of liability for statements of opinion, which does not require a showing of subjective falsity, only that facts were omitted that made the opinion objectively misleading to a reasonable investor. As the Supreme Court cautioned in *Omnicare*, however, meeting this standard will be “no small task for an investor.”⁵⁶

B. Second Circuit Splits with First Circuit Over the Standard for Materiality in an Omissions Case

In *Stadnick v. Vivint Solar*,⁵⁷ the Second Circuit confirmed that the operative test to determine whether omitted interim financial data requires disclosure under Section 11 is the traditional *TSC* standard of whether a reasonable investor would view the omission as “significantly altering the

⁵⁰ *Align Tech.*, 856 F.3d at 617.

⁵¹ *Id.* at 615.

⁵² *Id.* at 615-16.

⁵³ *Id.* at 616 (quoting *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund*, 135 S. Ct. 1318, 1332 (2015)).

⁵⁴ *Id.* at 617 (citation omitted).

⁵⁵ See *Tongue v. Sanofi*, 816 F.3d 199, 211-12 (2d Cir. 2016) (applying *Omnicare* to securities fraud claims arising under Section 10(b) and Rule 10b-5, in addition to Section 11, without distinguishing among the provisions).

⁵⁶ *Omnicare*, 135 S. Ct. at 1332.

⁵⁷ 861 F.3d 31, 36-38 (2d Cir. 2017).

total mix of information made available.”⁵⁸ In *Shaw v. Digital Equipment Corp.*, the First Circuit previously held that an omission may be material if the “nonpublic information indicat[es]” a substantial likelihood that the company’s performance or financial results “will be an extreme departure from the range of results which could be anticipated based on currently available information.”⁵⁹

In *Stadnick*, a stockholder brought Section 11 claims alleging that Vivint Solar Inc., a solar energy company, misled investors by including in its registration statement financial statements that omitted the latest quarterly metric of income available to stockholders and earnings per share.⁶⁰ The plaintiff argued that this information should have been disclosed because it evidenced an “extreme departure” from the company’s previous performance. Judge Katherine Forrest of the Southern District of New York dismissed the claims, holding that the “extreme departure” test was not implicated because all material financial information was “fully disclosed in [Vivint’s] Registration Statement.”⁶¹

The Second Circuit affirmed, but took the opportunity to reject the First Circuit’s “extreme departure test” in favor of the “total mix” test. The Second Circuit observed that the “total mix” test is the “classic” standard of materiality articulated by the Supreme Court over 40 years ago in *TSC Industries, Inc. v. Northway, Inc.*⁶² According to the Court, “*Shaw*’s ‘extreme departure’ test leaves too many open questions, such as: the degree of change necessary for an ‘extreme departure’; which metrics courts should look to in assessing whether such a departure has occurred; and the precise role of the familiar ‘objectively reasonable investor’ in assessing whether a departure is extreme.”⁶³ Moreover, the “extreme departure” test can be “analytically counter-productive” in situations like the one in *Vivint*, where there was indeed an “extreme departure” from Vivint’s past performance in the omitted metrics, but those metrics were not “fair indicators” of Vivint’s actual financial performance.⁶⁴ By contrast, the traditional materiality test “examines omissions in the context of the total mix of available investor information.”⁶⁵ In *Stadnick*, the alleged omissions did not meet this standard because “there was never a trend of the shareholders’ income increasing or decreasing,” Vivint’s total income and revenue was unaffected by shareholder income fluctuations,

⁵⁸ *DeMaria v. Andersen*, 318 F.3d 170, 180 (2d. Cir. 2003) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

⁵⁹ *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1210 (1st Cir. 1996).

⁶⁰ 861 F.3d at 36-38.

⁶¹ *Stadnick v. Vivint Solar, Inc.*, 2015 WL 8492757, at *13 (S.D.N.Y. Dec. 10, 2015).

⁶² *Vivint*, 861 F.3d at 37 (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)).

⁶³ *Id.* at 37-38.

⁶⁴ *Id.* at 38.

⁶⁵ *Id.*

and “Vivint’s registration statement contained ample warnings and disclosures that explained shareholder revenue and earning fluctuations.”⁶⁶

Although *Stadnick* expressly disavows the “extreme departure test,” it is not clear that the First Circuit ever viewed its holding in *Shaw* as more than an as-applied expression of the traditional standard for materiality set forth in *TSC Industries*. Notably, the *Shaw* court “reject[ed] any bright-line rule that an issuer engaging in a public offering is obligated to disclose interim operating results for the quarter in progress whenever it perceives a possibility that the quarter’s results may disappoint the market.”⁶⁷

C. Second Circuit Confirms That National Exchanges May Face Liability for Private Securities Fraud Claims

In *City of Providence, v. BATS Global Markets, Inc.*,⁶⁸ the Second Circuit reversed the dismissal of a class action asserting Section 10(b) claims against several national securities exchanges and high-frequency trading firms (“HFTs”), holding that the exchanges did not enjoy absolute immunity from private securities fraud suits.

The plaintiffs, on behalf of a putative class of investors, alleged that the exchanges manipulated market activity by developing products and services that disproportionately benefited and conferred trading advantages on HFTs. The complaint focused on three products and services: proprietary data feeds, co-location services and complex order types. The plaintiffs alleged that ordinary investors could not afford these products and services, which allegedly allowed HFTs to “front-run” ordinary investors by providing HFTs with data earlier than other market participants and facilitating HFT trades faster than trades for ordinary investors. The United States District Court for the Southern District of New York dismissed plaintiffs’ claims, holding that the exchanges were immune from suit, and the plaintiffs failed to state a Section 10(b) claim.

The Second Circuit reversed and remanded. The Court held that the exchanges did not enjoy absolute immunity from private securities litigation because the exchanges were not acting as market regulators in establishing the products and services.⁶⁹ The Court explained that the products and services at issue were not “regulatory commands by the exchanges compelling traders to behave in certain ways,” but rather constituted “conduct to operate [the exchanges’] own market . . . distinct from [their] oversight role”; thus, the exchanges were “not entitled to the same protections of immunity that would otherwise be afforded” to regulators because they were “acting

⁶⁶ *Id.* at 38-39.

⁶⁷ *Shaw*, 82 F.3d at 1210.

⁶⁸ --- F.3d ---, 2017 WL 6458383, at *2-12 (2d Cir. Dec. 19, 2017).

⁶⁹ *Id.* at *7-8.

as [] *regulated* entit[ies] – not [as] *regulator[s]*.”⁷⁰ Moreover, the Court held that allegations that the exchanges failed to disclose the manipulative effect of these products and services on trading for ordinary investors were sufficient to state a Section 10(b) claim.⁷¹

In his concurrence, Judge Raymond Lohier added as an additional justification for the holding his support for “deference to the SEC’s reasonable and persuasive position” on the questions raised in the appeal.⁷² In reaching this position, Judge Lohier relied on the Supreme Court’s 1944 decision *Skidmore v. Swift & Co.*, which held that an agency’s views may be given weight based on “the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade.”⁷³ It is unclear whether the Supreme Court, as currently composed, would be receptive to Judge Lohier’s rationale.⁷⁴

D. Utah District Court Reinstates the “Conduct and Effects” Test for Extraterritorial Securities Transactions in Actions Brought by the SEC

In *SEC v. Traffic Monsoon, LLC*, Judge Jill Parish of the United States District Court for the District of Utah held that the SEC may bring fraud claims arising from extraterritorial securities transactions to the extent there also is wrongful conduct within the United States.⁷⁵

Traffic Monsoon LLC sold “AdPacks” of fake page views and advertisement click-throughs that make a website appear more popular than it is by artificially inflating the website’s views. The AdPacks, which constituted 98% of Traffic Monsoon’s revenue, permitted customers to share in the revenue of Traffic Monsoon by receiving credits to their accounts if they clicked on a number of websites each day. 90% of customers who purchased AdPacks resided outside the United States and were presumed to have purchased the AdPacks in their home countries. The SEC brought a civil suit against Traffic Monsoon, alleging that the AdPacks constituted a Ponzi scheme in violation of Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act. Traffic Monsoon argued that the District Court lacked subject matter jurisdiction because Section 10(b) and Section 17(a) do not apply to extraterritorial securities transactions. Traffic Monsoon urged the Court to

⁷⁰ *Id.* at *8-9 (emphasis in original).

⁷¹ *Id.* at *9-10.

⁷² *Id.* at *12.

⁷³ *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

⁷⁴ See, e.g., *Scenic Am., Inc. v. Dep’t of Transp.*, 138 S. Ct. 2 (2017) (“[W]hatever one thinks of [deferring to agency interpretations] in statutory interpretation cases, it seems quite another thing to suggest that the doctrine (or something like it) should displace the traditional rules of contract interpretation too.”) (statement of Gorsuch, J., with whom the Chief Justice and Alito, J. joined); *Cuozzo Speed Tech., LLC v. Lee*, 136 S. Ct. 2131, 2148 (2016) (“In an appropriate case, this Court should reconsider that fiction of *Chevron* and its progeny.”) (Thomas, J., concurring).

⁷⁵ *SEC v. Traffic Monsoon, LLC*, 245 F. Supp. 3d 1275, 1288-95 (D. Utah 2017).

apply the Supreme Court's transactional test articulated in *Morrison*, which confers jurisdiction over securities transactions "only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."⁷⁶

The District Court disagreed, holding that it possessed subject matter jurisdiction under the "conduct and effects" test, which extends the reach of the federal securities laws to extraterritorial transactions where "(1) conduct within the United States that constitutes significant steps in furtherance of the violation, . . . or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States."⁷⁷ Although the Supreme Court's decision in *Morrison* replaced the "conduct and effects" test with a transactional test, the District Court held that Section 929P(b) of the Dodd-Frank Act superseded *Morrison*. Examining the "legal context in which [Section 929P(b)] was drafted, legislative history, and the expressed purpose of the amendment," the Court concluded that Congress intended that, in actions brought by the SEC, Sections 10(b) and 17(a) should be applied to extraterritorial transactions to the extent that the conduct and effects test can be satisfied.⁷⁸ Applying the test, the Court held that it had jurisdiction over the SEC's claims because Traffic Monsoon took significant steps in furtherance of the "AdPack" scheme within the United States, noting that Traffic Monsoon was "conceived and created . . . in the United States" and "promoted the AdPack investments over the internet while . . . in Utah."⁷⁹ In the alternative, the Court held that *Morrison*'s transactional test was satisfied because Traffic Monsoon "sold all of the AdPacks over the internet to both foreign and domestic purchasers."⁸⁰

The District Court's decision, which is on appeal to the Tenth Circuit,⁸¹ is the first federal court decision to hold that the Dodd-Frank Act reinstated the conduct and effects test for securities fraud actions brought by the SEC and the Department of Justice.⁸² If the decision stands, it will likely increase the risk of liability through SEC or DOJ enforcement actions for companies offering securities globally. The District Court noted, however, that "Section 929P(b) is explicitly limited to actions brought by the SEC or the United States. Thus, *Morrison* would still control in a private cause of action brought under Section 10(b)."⁸³ Therefore, *Morrison* continues to provide

⁷⁶ *Morrison*, 561 U.S. at 273.

⁷⁷ *Traffic Monsoon*, 245 F. Supp. 3d at 1294 (quoting § 929P(b), 124 Stat. 1376, 1864–65 (2010)).

⁷⁸ *Id.* at 1293-94.

⁷⁹ *Id.* at 1294.

⁸⁰ *Id.* at 1294-95.

⁸¹ *Traffic Monsoon, LLC*, 245 F. Supp. 3d 1275 (D. Utah 2017), *appeal docketed*, No. 17-4059 (10th Cir. April 17, 2017).

⁸² *Id.* at 1292 (reviewing legislative history explaining that the "purpose" of Section 929P(b) "is to make clear that in actions and proceedings brought by the SEC or the Justice Department, the specified provisions of the Securities Act, the Exchange Act and the Investment Advisers Act may have extraterritorial application") (citation omitted).

⁸³ *Id.* at 1294 n.10.

companies offering securities abroad a meaningful basis to support a motion to dismiss (and oppose class certification under the Second Circuit's *Petrobras* decision, described above).

IV. Insider Trading

In *United States v. Martoma*,⁸⁴ the Second Circuit held that tippees may be convicted for trading on material, non-public information conveyed to the tippee as a gift, even if the tipper and tippee do not share a “meaningfully close relationship” as had been required by the Second Circuit in its decision in *United States v. Newman*.⁸⁵

In *Newman*, the Second Circuit held that a tipper's gift of information constitutes a personal benefit sufficient to support insider trading liability only if there is some “proof of a meaningfully close personal relationship [between the tipper and tippee] that generates . . . at least a potential gain of a pecuniary or similarly valuable nature.”⁸⁶ *Newman* thus narrowed the scope of impermissible insider trading to situations where the tipper had a “close personal relationship” to the tippee and stood to receive a “potential gain” from the gift. The Supreme Court disagreed with this aspect of *Newman* in its 2016 decision *Salman v. United States*, explaining that “[t]o the extent the Second Circuit held that the tipper must also receive something of a ‘pecuniary or similarly valuable nature’ in exchange for a gift to family or friends . . . this requirement is inconsistent with [the Supreme Court's 1983 decision] *Dirks v. SEC*.”⁸⁷

In *Martoma*, the Second Circuit confirmed that the “meaningfully close relationship” test set forth in *Newman* is “no longer good law.”⁸⁸ There, Matthew Martoma, an investment manager, consulted with doctors regarding a new Alzheimer's drug then in clinical trials. After learning of negative test results from one of the doctors involved in the testing, Martoma's investment company sold its positions in the companies developing the drug before the results became public, avoiding an estimated \$194.6 million dollar loss. Martoma was charged and convicted of insider trading by a jury in the Southern District of New York. Martoma appealed to the Second Circuit, arguing that under *Newman*, the jury was not properly instructed that the government must prove Martoma and the doctor who gave him the tip shared a “close personal relationship.”

The Second Circuit rejected Martoma's argument, concluding that the Supreme Court's decision in *Salman* superseded *Newman*'s “meaningfully close relationship” requirement. The Court explained that a tipper's gift of insider information is the “functional equivalent of trading on the information

⁸⁴ 869 F.3d 58 (2d Cir. 2017).

⁸⁵ 773 F.3d 448, 452-55 (2d Cir. 2014).

⁸⁶ *Id.* at 452 (emphasis added).

⁸⁷ 136 S.Ct. 899, 428 (2016) (citing *Dirks v. SEC*, 463 U.S. 616 (1983)).

⁸⁸ *Martoma*, 869 F.3d at 69.

himself and giving a cash gift to the recipient.”⁸⁹ “[T]he personal benefit one receives from giving a gift of inside information is not the friendship or loyalty or gratitude of the recipient of the gift; it is the imputed pecuniary benefit of having effectively profited from the trade oneself and given the proceeds as a cash gift.”⁹⁰ If an insider discloses information “with the expectation that [the recipient] would trade on it . . . and the disclosure resemble[s] trading by the insider followed by a gift of the profits to the recipient,” then the personal benefit requirement is satisfied.⁹¹ Applying this framework, the Court held that the evidence was sufficient to show that the doctor who gifted Martoma the confidential clinical trial information received a personal benefit giving rise to liability.⁹²

Although *Salman* and *Martoma* laid to rest *Newman*'s holding that a tipper must have a “meaningfully close personal relationship” with a tippee and must receive something of a “pecuniary or similarly valuable nature” in return for the gift of information, the decisions do not appear to affect the aspect of *Newman*'s holding that the government cannot meet its burden “without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure.”⁹³ That was not at issue in *Martoma* or *Salman*. Thus, in future cases, defendants may continue to raise the argument that, although a gift may have been provided, the government did not meet its burden of demonstrating that a remote tippee had knowledge of the benefit received by the insider for disclosing the information. That argument may not be viable, however, unless, as in *Newman*, the remote tippee “‘knew next to nothing’ about the tipper[], [was] unaware of the circumstances of how the information was obtained, and ‘did not know what the relationship between the [tipper] and the first-level tippee was.’”⁹⁴

V. Indemnification

In *Perry v. Duoyuan Printing, Inc.*,⁹⁵ Judge George Daniels of the United States District Court for the Southern District of New York ruled that an underwriter could not maintain a claim for contractual indemnity arising out of the settlement of a securities action because enforcement would contravene public policy.

The Second Circuit has long held that the public policy embodied in the federal securities laws prohibits indemnity in favor of a defendant found to have “committed a sin graver than ordinary

⁸⁹ *Id.*

⁹⁰ *Id.* at 72.

⁹¹ *Id.* at 69-70 (internal quotation marks omitted).

⁹² *Id.*

⁹³ *Newman*, 773 F.3d at 448.

⁹⁴ *SEC v. Payton*, 97 F. Supp. 3d 558, 564 (S.D.N.Y. 2015) (Rakoff, J.) (quoting *Newman*, 773 F.3d at 453-54).

⁹⁵ *Perry v. Duoyuan Printing, Inc.*, 232 F. Supp. 3d 589, 593-95 (S.D.N.Y. 2017).

negligence.”⁹⁶ This concept has been applied to prohibit indemnification claims brought by a defendant who “settles securities law claims without admitting fault, unless that party actually demonstrates that it is without fault.”⁹⁷

In *Perry*, investors brought a putative class action asserting Section 11 and Section 10(b) claims against Duoyuan Printing, Inc., a Chinese publishing machinery company, and its underwriters for overstating the company’s revenues in connection with its IPO. After both Duoyuan and the underwriters settled with plaintiffs without admitting fault, the underwriters filed cross-claims against Duoyuan seeking indemnification under underwriting agreements in which the issuer agreed to “indemnify and hold harmless each Underwriter.”

The Court dismissed the underwriters’ indemnification claims. Notably, the Court declined to give the underwriters an opportunity to prove the absence of fault.⁹⁸ The Court noted that, in previous cases in which indemnification was allowed, the indemnitor either stipulated or was adjudicated at trial to be more at fault than the settling co-defendant who sought indemnification.⁹⁹ That was not the case here. Moreover, the Court observed that the underwriters “produced no evidence . . . to demonstrate they were without fault,” and the denial of their motion to dismiss in the underlying securities fraud action “weigh[ed] against a finding that they successfully demonstrated their lack of fault.”¹⁰⁰ Rather than allow a settling party to re-litigate the settled claim, the court reasoned, the public policy against indemnifying wrongdoing embodied in the securities law must prevail over the general policy of encouraging settlements.¹⁰¹

Judge Daniels’ ruling has received scant attention from courts and commentators since it was issued in early 2017. If other courts follow its holding, however, it could have significant implications for underwriters, including precluding underwriters from being indemnified in securities settlements (absent a stipulation or adjudication that the underwriter is less at fault than the indemnitor), and potentially increasing underwriter fees. At minimum, *Perry* should encourage underwriters to enter into global securities settlements, including with settling co-defendants, instead of relying on potentially unenforceable indemnification agreements.

⁹⁶ *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969).

⁹⁷ *Credit Suisse First Boston, LLC v. Intershop Comm’ns AG*, 407 F. Supp. 2d 541, 547 (S.D.N.Y. 2006).

⁹⁸ *Perry*, 232 F. Supp. 3d at 595.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at 594.

¹⁰¹ *Id.*

VI. Whistleblower Actions

On June 26, 2017, the Supreme Court granted certiorari in *Digital Realty Trust, Inc. v. Somers*¹⁰² to decide whether Dodd-Frank Act's anti-retaliation provisions apply to whistleblowers who internally "report up" securities violations to senior management rather than "report out" to the SEC. The Supreme Court heard oral argument on November 28, 2017.

The Dodd-Frank Act protects "any individual who provides . . . information relating to a violation of the securities laws to the [Securities and Exchange Commission]."¹⁰³ The SEC's implementing regulations broadly define "whistleblower" as anyone who "possess[es] a reasonable belief that the information [they] are providing relates to a possible securities law violation."¹⁰⁴ In the SEC's view, this would apply to an employee's internal reporting of alleged securities violations, even if the employee never reported the violations to the SEC.¹⁰⁵

In a matter of first impression, the Ninth Circuit held that the Dodd-Frank Act's anti-retaliation protection for "whistleblowers" extends to employees who alert senior company management of potential securities violations even if they do not alert the SEC.¹⁰⁶ The Court explained that this broad interpretation "accurately reflects congressional intent that [the Dodd-Frank Act] protect employees whether they blow the whistle internally, as in many instances, or they report directly to the SEC."¹⁰⁷ The Ninth Circuit's decision aligns with the Second Circuit,¹⁰⁸ but conflicts with the Fifth Circuit, which previously rejected the SEC's interpretation and ruled that individuals who report internally but not to the SEC are not protected by Dodd-Frank's anti-retaliation provisions.¹⁰⁹

The Supreme Court's decision could have significant implications for corporate compliance programs. If the Supreme Court agrees with the Ninth Circuit, employees will be emboldened to report securities violations internally, and employers will likely face litigation if they terminate such employees. On the other hand, if the Supreme Court reverses, internal compliance programs could be compromised in that greater numbers of whistleblowers may report to the SEC without first reporting internally, thereby depriving companies of the opportunity to attempt to address the issue,

¹⁰² 850 F.3d 1045, 1051 (9th Cir. 2017), *cert. granted*, 137 S. Ct. 2300 (U.S. June 26, 2017) (No. 16-1276).

¹⁰³ 15 U.S.C. § 78u-6(a)(6).

¹⁰⁴ 17 C.F.R. § 240.21F-2(b)(1).

¹⁰⁵ *Id.*

¹⁰⁶ *Somers*, 850 F.3d at 1051.

¹⁰⁷ *Id.*

¹⁰⁸ *Berman v. Neo@Ogilvy LLC*, 801 F.3d 145, 155-59 (2d Cir. 2015).

¹⁰⁹ *Asadi v. G.E. Energy (USA), L.L.C.*, 720 F.3d 620, 621 (5th Cir. 2013).

including by conducting an internal investigation if appropriate, and determine whether or not to make voluntary disclosure to the government.¹¹⁰

VII. Securities Regulation and Enforcement

A. SEC Treats Certain Applications of Crypto-Currencies as Securities

In 2017, the SEC stepped up enforcement efforts in connection with crypto-currencies. Crypto-currencies, like bitcoin, are “digital representation[s] of value that can be digitally traded and function as a medium of exchange, unit of account, or store of value.”¹¹¹

In March, the SEC refused to allow the BATS BZX Stock Exchange to list the stocks of “Bitcoin trusts,” investment trusts intended to track the market price of bitcoins.¹¹² The SEC compared the bitcoin trusts to previously-approved securities that track commodity prices, but observed that bitcoin markets differ because they are unregulated and susceptible to manipulation. Since the SEC was skeptical that the exchange could enter into “the type of surveillance-sharing agreement that helps address concerns about the potential for fraudulent or manipulative acts and practices in the market for the Shares,” the SEC concluded that allowing the exchange to list the stocks of bitcoin trusts would violate the SEC’s duty to prevent fraud under Section 6(b)(5) of the Exchange Act.¹¹³

In July, the SEC issued a report on its investigation of “The DAO,” a virtual organization that issued “DAO Tokens,” which granted holders certain voting and ownership rights in The DAO.¹¹⁴ In its discussion of whether the DAO Tokens constituted securities, the SEC confirmed that traditional principles of securities law—including the *Howey* test—applied¹¹⁵ to distributed ledger or blockchain related means to raising capital, and concluded that the tokens, which The DAO offered and sold to the public through web-based platforms, were “investment contracts” and thus fell within the definition of “securities” subject to regulation.¹¹⁶ In making this determination, the SEC explained that purchasers invested in DAO Tokens with an expectation that The DAO would fund projects to earn profits that “would provide DAO Token holders a return on investment.”¹¹⁷ Further,

¹¹⁰ See Steven Kohn, *Digital Realty Trust v. Somers May Kill Corporate Compliance*, Law 360 (Sept. 21, 2017), <https://www.law360.com/articles/964208/digital-realty-trust-v-somers-may-kill-corporate-compliance>.

¹¹¹ *Id.*

¹¹² SEC Release No. 34-80206 (March 10, 2017), <https://www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf>.

¹¹³ *Id.* at 19-20.

¹¹⁴ Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (July 25, 2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

¹¹⁵ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

¹¹⁶ The DAO, SEC Release No. 81207.

¹¹⁷ *Id.* at 6.

the SEC determined that holders' profits were derived from the managerial efforts of others, including Slock.it, the website that sold the DAO tokens and actively oversaw the operations of the DAO.¹¹⁸ Although the SEC declined to bring an enforcement action in this case (in part because The DAO had ceased operations), the SEC warned that future offerings of similar tokens may need to be registered.¹¹⁹

On the heels of its DAO ruling, the SEC is likely to redouble its enforcement efforts in connection with crypto-currencies, which continue to rise in popularity and value both in the United States and globally. In addition to confirming that individuals and entities that use crypto-currencies to raise capital or investment can be subject to securities regulation, the SEC recently has focused on public awareness. In December, Chairman Clayton offered guidance for both "main street investors" and "market professionals," including that crypto-currency markets have "substantially less investor protection than in our traditional securities markets" and "greater opportunities for fraud and manipulation," and "[s]elling securities generally requires a license, and experience shows that excessive touting in thinly traded and volatile markets can be an indicator of 'scalping,' 'pump and dump' and other manipulations and frauds."¹²⁰ In light of these concerns, Chairman Clayton also warned that "gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities."¹²¹

B. SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors

In August, the SEC's Office of Compliance Inspections and Examinations ("OCIE") announced the results of its second survey of cybersecurity at regulated broker-dealers, advisers, and funds.¹²² In an improvement over its 2014 survey results, OCIE found that most regulated entities have implemented vendor risk assessment/monitoring processes, and many entities require regular updates to keep their diligence current. OCIE identified three areas of weakness: (1) vague, confusing, or overly generic employee guidance; (2) inconsistent implementation of annual or ongoing reviews; and (3) inconsistent remediation of identified vulnerabilities and irregular updating and patching of software and systems.¹²³

¹¹⁸ *Id.* at 11-15.

¹¹⁹ *Id.* at 15-18.

¹²⁰ SEC Chairman Jay Clayton, "Statement on Cryptocurrencies and Initial Coin Offerings," <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

¹²¹ *Id.*

¹²² OCIE, National Exam Program, Risk Alert: Observations from Cybersecurity Examinations (Aug. 7, 2017) <https://www.sec.gov/files/observations-from-cybersecurity-examinations.pdf>.

¹²³ *Id.*

In September, the Enforcement Division established an official “Cyber Unit.”¹²⁴ Co-Director of the Enforcement Stephanie Avakian explained that “[t]he Cyber Unit will enhance our ability to detect and investigate cyber threats through increasing expertise in an area of critical national importance.”¹²⁵ In addition to targeting hackers who engage in insider trading, the Cyber Unit may bring enforcement actions for failures to implement adequate cybersecurity measures such as those identified in the OCIE survey.¹²⁶

In October, Chairman Clayton stated in testimony before Congress, “I still am not confident that the Main Street investor has received a sufficient package of information from issuers, intermediaries and other market participants to understand the substantial risks resulting from cybersecurity and related issues . . . I would like to see more and better disclosure in this area.”¹²⁷

C. SEC Attempts to Resolve Legitimacy of Administrative Law Judges

In November, the Commission ratified the appointments of the SEC’s Administrative Law Judges (“ALJs”) and directed the ALJs to reconsider the record in all pending decisions.¹²⁸ The actions were an attempt to resolve ongoing questions concerning the ALJs’ authority in the face of challenges to their legitimacy under the Appointment Clause of the Constitution.

In 2016, two U.S. Circuit Courts of Appeal reached conflicting interpretations on whether the installation of the ALJs without any presidential or Commission appointment is unconstitutional. Under the Appointments Clause, “inferior officers” must be appointed by the President, or if statute provides, by a court or a department head.¹²⁹ “Inferior officers” has been interpreted to mean government officers who exercise “significant authority” under the law.¹³⁰ SEC ALJs are selected without any presidential or Commission appointment. Therefore, if they are deemed “inferior officers” their authority would be in doubt. In *Raymond J. Lucia Cos. v. SEC*, the D.C. Circuit averted this outcome by deeming the ALJs to be mere employees whose decisions are referred to the Commission for final approval.¹³¹ In *Bandimere v. SEC*, however, the Tenth Circuit concluded that ALJs are inferior officers whose duties require them to “exercise significant discretion in

¹²⁴ SEC Release 2017-176 (Sept. 25, 2017), <https://www.sec.gov/news/press-release/2017-176>.

¹²⁵ *Id.*

¹²⁶ 17 C.F.R. § 248.30(a).

¹²⁷ Testimony of Jay Clayton before the U.S. House of Representatives Committee on Financial Services (Oct. 4, 2017), <https://www.sec.gov/news/testimony/testimony-examining-secs-agenda-operation-and-budget>.

¹²⁸ *In re: Pending Administrative Proceedings*, Securities Act Release No. 10440 (Nov. 30, 2017), <https://www.sec.gov/litigation/opinions/2017/33-10440.pdf>.

¹²⁹ U.S. Const., art. II, § 2, cl. 2.

¹³⁰ *Buckley v. Valeo*, 424 U.S. 1, 126 (1976).

¹³¹ *Raymond J. Lucia Cos., Inc. v. SEC*, 832 F.3d 277, 286 (D.C. Cir. 2016).

performing “important functions.”¹³² Thus, the Tenth Circuit set aside the opinion of an SEC ALJ so appointed because the “ALJ held his office unconstitutionally.”¹³³

The SEC’s action to ratify its ALJs came in the midst of the Supreme Court’s consideration of a petition for certiorari filed in *Lucia*.¹³⁴ In connection with that petition, the U.S. Solicitor General filed a brief agreeing with the petitioner that the Supreme Court should grant certiorari and deem the ALJs to be “Officers of the United States” subject to the Appointments Clause. The petition for certiorari is currently fully briefed and pending the Supreme Court’s decision.

D. Financial CHOICE Act Would Alter SEC Enforcement Practices

In June, the Financial CHOICE Act (the “Choice Act”)¹³⁵ passed the House of Representatives and was referred to the Senate Banking Committee, where it remains pending.

If enacted in its current form, the Choice Act would alter various SEC enforcement:

- The Choice Act would require the SEC Staff to provide recipients of “Wells Notices” an opportunity to make in-person presentations that the Commissioners would be allowed to attend.¹³⁶
- The Choice Act would require that, before the Commission may bring an enforcement action seeking civil monetary penalties from a corporation, the Staff present the Commission with an economic analysis identifying any economic benefit the issuer derived from the alleged violation and determining whether shareholders would be harmed by the penalty sought.¹³⁷
- The Choice Act would mandate that the SEC implement time limits on investigations¹³⁸ and formally close investigations if no enforcement action is to be taken.¹³⁹
- The Choice Act would present respondents to SEC enforcement actions brought in administrative proceedings with a choice: A respondent may elect to remove the case to federal district court or to move forward with the administrative proceeding under an elevated “clear and

¹³² *SEC v. Bandimere*, 844 F.3d 1168, 1179 (10th Cir. 2016).

¹³³ *Id.* at 1188.

¹³⁴ *Lucia v. SEC*, No. 17-130 (U.S.).

¹³⁵ Financial CHOICE Act of 2017, H.R. 10, 115th Cong. (2017-2018).

¹³⁶ H.R. 10, 115th Cong. (2017), § 821.

¹³⁷ *Id.* § 824.

¹³⁸ *Id.* § 826.

¹³⁹ *Id.* § 817.

convincing evidence" standard of proof.¹⁴⁰ If the case proceeds in federal court, the standard of proof by "preponderance of the evidence" would remain unchanged.¹⁴¹

* * *

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¹⁴⁰ *Id.* § 823.

¹⁴¹ *Id.* § 823.