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Financial Regulation in the United States and the Role of the SEC: Selected Developments

Consob Seminar – April 5, 2019

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Fintech and Digital Assets

SEC Regulatory Guidance and Enforcement Actions

Digital Assets, ICOs and the SEC’s Jurisdiction

- Cryptocurrencies and digital assets: decentralized, digital currencies that rely on blockchain technology
  - *Virtual currencies*: Typically possess their own independent blockchain and the overt purpose is to act like money
  - *Digital tokens*: Typically are hosted on top of another pre-existing blockchain, require a platform to exist and operate on, and provide users with future access to a product or service
- The Securities and Exchange Commission (“SEC”) has jurisdiction over digital assets that qualify as “securities” under the Securities Act of 1933, as amended.
  - SEC Chairman Clayton indicated that Bitcoin are more akin to sovereign currencies than securities; William Hinman, Director of the Division of Corporate Finance, has also stated he does not believe that Ether are securities
  - Other digital assets, especially tokens offered in initial coin offerings (“ICOs”), may qualify as securities at the time of the offering under the definition of “investment contract” pursuant to the *Howey* test (e.g., generally speaking, if there is an investment of money in a common enterprise with an expectation of profits derived from the efforts of others); the determination of whether or not assets are “securities” may evolve over time
  - SEC Chairman Clayton stated in testimony to the US Senate in February 2018 that: “I believe every ICO I’ve seen is a security and we have jurisdiction and our federal securities laws apply”

Recent SEC Guidance on Digital Assets

June 2018 Speech by the Director of the Division of Corporate Finance, William Hinman

- **A digital asset "all by itself is not a security"**
  - But ***how the asset is sold*** and the ***reasonable expectations of purchasers*** may result in a securities transaction
  - The economic reality of the transaction is more important than form or labels
    - Where the ability to realize a profit relies on the efforts of another to run the enterprise, investors need adequate disclosure to make informed decisions about that party and about the investment as a whole
  - Other factors issuers and promoters of digital assets should consider:
    - Are the digital assets sold to raise money to fund an enterprise?
    - Is the primary motivation for purchasing the digital asset investment, rather than consumption or personal use?
    - Is the digital asset marketed to the general public, rather than potential users of the system?
    - Is the promoter supporting the secondary market, rather than independent market actors setting the price?
- **The securities law analysis is not static**
  - A digital asset originally offered as a security can potentially later be sold without being a securities offering
  - Bitcoin and Ether are sufficiently decentralized that the securities laws provide limited protections to their holders (it would be difficult to identify an issuer or promoter who should make disclosures and who may be held liable)
  - As purchasers no longer expect a person or group to carry out essential managerial or entrepreneurial efforts, material information asymmetries recede
- SEC Chairman Clayton endorsed Director Hinman's views in a March 2019 letter to Congress

Recent SEC Guidance on Digital Assets

April 2019 Guidance on Investment Contract Analysis of Digital Assets

- On Wednesday, April 3, SEC staff concurrently released a framework for analyzing whether a digital asset qualifies as an offer or sale of securities and no-action relief to a company to issue digital assets without registering them as securities
- **Key Takeaways**
  - The framework and relief clarify and expand upon the general factors addressed in Director Hinman's speech
    - The framework contains prescriptive guidance on conditions that may turn digital assets into investment contracts within the meaning of the securities law
    - The no action letter provides relief for an entity to create a private, permissioned and centralized blockchain and to issue a token that can be used as a prepaid device to purchase goods and services, with transactions recorded on the blockchain
  - The continuing role of a sponsor or promoter in a digital asset network typically weighs in favor of the digital asset being a security
  - If the digital asset network is currently functional and members can exchange the digital asset for goods and services on the network, this typically weighs against the digital asset being a security
  - Several factors concern the correlation of the price and frequency of trading of the digital asset to the goods and services on the network, factors that may be outside of the promoter's control
  - Some room was left for role of capital appreciation in digital assets, with the guidance noting economic benefits derived from appreciation may be "incidental" to the use the digital asset is intended and prospects of appreciation must be "limited"

Recent SEC Enforcement on Digital Assets and Market Pushback

- The SEC has publically prioritized protecting retail customers (including in ICOs)
  - Recent remedies have focused on ensuring investors receive the type of information they would have received in a registered offering and giving them a rescission option if they have lost money in an unregistered offering
  - The SEC has provided a path to compliance and continued operation for ICOs that violate the securities laws
- **Recent enforcement examples**
  - *Gladius*: SEC settled, without monetary penalties, with a company that self-reported its failure to register its tokens; defendant promised to compensate investors and register its tokens
  - *Airfox*, *Paragon* and *Munchee*: SEC settled, with monetary penalties and disgorgements, with companies that failed to register ICOs, but that committed no misrepresentations or fraud
  - *Blockvest*: California federal court reconsidered, in the SEC's favor, a prior decision that the SEC had failed to demonstrate the tokens were securities under the *Howey* test, reversing a rare defeat for the SEC
  - *Mayweather* and *Khaled*: SEC settled, with monetary penalties and disgorgement, respectively, with two celebrities for failing to disclose payments received for promoting ICOs
- **Kik Interactive's Wells Submission**
  - Announcing it would fight potential SEC enforcement for failure to register its token (Kin), Kik Interactive published its Well Submission refuting that Kin is a security, arguing that:
    - Kin has always been marketed as a medium of exchange (i.e., consumptive use), with over 30 companies accepting some form of Kin payments and induvial ICO purchases ranging from $0.09 to a cap of $4,400
    - The Kin network was always meant to be decentralized and not controlled by Kik
    - Any expectation of value that purchasers had related to market fluctuations, and Kik has not facilitated a secondary market for Kin

SEC Guidance and Enforcement on Digital Asset Exchanges

- Chairman Clayton has stated concern that digital asset exchanges and even some companies conducting ICOs often look like exchanges requiring registration and yet are not registered as such
- **Joint Statement of SEC Staff (November 2018)**
  - Entities that provide algorithms that bring together buyers and sellers or execute orders (whether on a program or by a smart contract using blockchain technology) may be "***trading facilities***"
  - Systems that display trading interests to users or receive users' orders centrally for future processing and execution may "***bring together orders of multiple buyers and sellers***"
  - Entities that set execution priorities, standardize material terms for traded digital assets or require orders to conform with smart contract protocols may be "***setting rules***"
- ***In the Matter of Zachary Coburn*** **(November 2018)**: First enforcement action against a digital assets trading platform
  - <u>Unusual form</u>: Defendant's company, EtherDelta, did not operate like a traditional exchange with centralized operations, having no ongoing active management of the platform's order taking and execution functions
    - A decentralized approach connected buyers and sellers through pre-established smart contract protocols upon which all operational decisions were carried out
  - <u>SEC Complaint</u>: Substance over form – EtherDelta qualified as an exchange
    - Operated as a marketplace to bring together buyers and sellers of tokens (including "securities")
    - Orders were publically posted on an order book and all live buy and sell orders were listed and sorted by price
    - Developed smart contract trading protocols that established non-discretionary methods to facilitate order entry and execution
  - <u>Takeaways</u>:
    - Enforcement: Cease and desist order along with a civil monetary penalty, disgorgement and pre-judgment interest
    - The SEC charged an individual, not the entity (Coburn sold EtherDelta to a Chinese acquirer and EtherDelta is still in operation)
    - The SEC never stated in its settlement which of the tokens traded on EtherDelta were securities

Digital Assets and Investment Advisers

SEC Request for Comments on Non-DVP Custodial Practices

- The SEC Division of Investment Management published a letter to the Investment Advisers Association requesting comments on possible revisions to the "Custody Rule" as well as the rule's application to digital assets
- **Custody Rule**:
  - The Custody Rule requires SEC-registered investment advisers that possess custody of client funds or securities to keep those assets with a "qualified custodian"
    - The SEC does not construe the authority to withdraw client funds or securities to effect and settle trades as "custody" over those assets
  - The SEC has yet to clarify if digital assets qualify as "funds" under the rule, but many advisers have adopted the rule
- **Selected topics SEC requested feedback on**:
  - How can distributed ledger technology ("DLT") – e.g., blockchain – be used to provide enhanced or diminished client protections?
  - What challenges do investment advisers face in complying with the Custody Rule with respect to digital assets?
  - How should concerns about misappropriation of digital assets be addressed and how does DLT play a role?
  - What is the settlement process of peer-to-peer digital asset transactions?
- **Takeaways**
  - The SEC is continuing to work on establishing appropriate requirements for custody of digital assets by regulated advisers, based on input from knowledgeable market participants

Fintech and Digital Asset Developments Beyond the SEC

- **Commodities Regulation**
  - The Commodity Futures Trading Commission ("CFTC") takes the position that all digital assets are commodities subject to CFTC jurisdiction for fraudulent or manipulative conduct; its jurisdiction extends to the regulation of sales and trading of derivatives on digital assets
    - *See, e.g.*, *CFTC v. My Big Coin Pay, Inc.*: Federal district court accepted the CFTC's position that digital assets are commodities
- **State Regulation of Fintech and Digital Assets**
  - In the US, consumer lending, payments and money transmission are regulated at the state level for non-bank fintech companies, leading to a patchwork regulatory structure
  - Selected approaches of US states:
    - <u>Money transmission laws</u>
      - *See, e.g.*, *State of Florida v. Espinoza*: Selling one's own bitcoin into or from Florida for cash qualifies as money transmitting, requiring a license
    - <u>State securities (or "blue skies") laws</u>
      - *See, e.g.*, *In the Matter of Bitconnect* (Texas State Securities Board): Cease and desist order against a UK company offering digital assets to Texas residents where the assets qualified as securities and were not registered with the state regulator
    - <u>New York State "Bitlicense"</u>
      - New York finalized a regime requiring licensing for businesses engaged in "virtual currency business activity"; licensed businesses will need to comply with various state business and consumer protection laws

Shareholder Activism; Say-on-Pay; and Environmental, Social and Governance (“ESG”) Criteria

Shareholder Activism

- Shareholder activism is increasingly targeting large, well-known companies
  - *See, e.g.*, General Motors, Johnson & Johnson, DowDuPont, P&G and Deutsche Bank
- Activist investors are no longer required to acquire a greater than 5% stake or wage a proxy contest to achieve objectives
  - ValueAct obtained a board seat at Microsoft and ousted the CEO with only a 0.8% stake
  - Carl Icahn pressured Apple to accelerate expansion of its share buyback program with only a 0.9% stake
- Changing nature of investors
  - Increased pressure on actively managed funds to improve returns to compete with passive funds (shareholder activism as proving the fund manager is a source of good ideas for issuers)
  - Passive-strategy funds are increasingly becoming more involved in governance issues through annual letters, position papers and supporting other activist investors
  - Proxy advisory firms have increasing weight in shareholder proxy voting
- Common activist tactics
  - Push to remove a minority of the board with "industry experts" or principals of the activist fund
  - Media campaigns and white papers
  - Use of ESG concerns to convince governance-focused investors of the activist's position

Shareholder Activism

- **Settlement vs. fight calculus**
  - Pain, distraction and costs for both companies and activists have made settlements the norm
    - 78% of director appointments resulting from activist campaigns in 2018 were via settlement
    - Institutional investors have generally been welcoming of settlement announcements with activists even though they rarely play a role in the negotiation (or even have advance warning)
- **Common settlements**
  - Primary “win” that activists seek is a public announcement by the company of a commitment to a long-term target metric (e.g., a three-year target on margins) or a shift in strategic direction (e.g., agreement to explore separation of a division or a “strategic alternatives” process)
  - Consultants: Settlement agreements increasingly commit boards to work with outside consulting firms, which have become increasingly aligned with activist perspectives
- **Defenses to activists investors**
  - Poison pills
  - Having response plans ready and keeping boards prepared
  - Explore strategic alternatives
- **Activist investor requests to meet with independent directors**
  - General advice is that investor meet first with management; however, allowing the meeting can diffuse tensions
  - Directors need to be prepared to avoid Reg FD violations, embarrassing publicity or making commitments
  - Directors who engage regularly with the investor relations function of the company are often best suited for this

Shareholder Activism

Recent Cases

- **eBay**
  - Two funds, Elliot Management and Starboard Value, each recently acquired around 4% of eBay
  - Both funds have been pushing eBay to sell off its ticket-reselling business (StubHub) and online classified-ads businesses
  - eBay settled with the firms, agreeing to:
    - Add two directors affiliated with the funds and a new independent director
    - Launch a strategic review of the business to consider whether it should unwind non-core businesses or expand into businesses that complement the core business
- **BP and Royal Dutch Shell**
  - Activist group FollowThis, whose members include 4,300 retail shareholders, filed a shareholder resolution with BP calling for the company to set hard targets for cutting carbon emissions, including emissions of third parties
  - FollowThis successfully pushed Shell to set short term targets to reduce carbon emissions
- **Barclays**
  - Activist investor Edward Bramson pledged to seek a seat on Barclays board, calling for Barclays to wind down parts of its investment banking division, which he sees as a drain on the bank's capital
  - Barclays response:
    - The head of Barclays investment bank was ousted in March, putting greater control of day-to-day operations in the CEO
    - Announced a share buyback program on the back of 2018 profit growth
    - Prominent shareholder that has backed Bramson in the past publically stated it would vote against Bramson's proposal

Say-on-Pay

- The SEC adopted "say-on-pay" rules governing public companies in 2011 as required by Dodd-Frank
  - The rules require that shareholders are provided with an advisory vote on the pay of executive officers at least once every three years
  - Additionally, a non-binding vote on how often shareholders would like to be presented with a say-on-pay vote must occur every six years
  - Companies must provide disclosure to shareholders on "golden parachute" compensation arrangements in connection with merger transactions and a separate shareholder advisory vote must be held to approve such arrangements
- A recent report by the executive compensation consultant Semler Brossy found that in 2018:
  - CEO pay ratio disclosure had little impact on say-on-pay vote results
  - Say-on-pay votes that passed were approved by 90.2% of shareholders on average in 2018, roughly in line with votes since 2012
  - 2.6% of say-on-pay votes failed in 2018
  - Institutional Shareholder Services ("ISS"), the influential proxy advisory firm, recommended "against" on 14% of say-on-pay votes; shareholder support was 31% lower at companies where ISS recommended a vote of "against"

Other Executive Compensation Rules

- The SEC say-on-pay rules satisfied only one of the rule-making requirements of Dodd-Frank relating to executive compensation
  - Eight executive compensation rules have been adopted, while four are still only in a proposed state, the lowest percentage of adopted rules of any of the categories of the SEC's required Dodd-Frank rulemaking
  - **Selected Approved Rules**
    - Several rules relating to the role and independence of a board's compensation committee
    - A rule requiring public companies to disclose the ratio of the compensation of its chief executive officer to the median compensation of its employees
  - **Selected Proposed Rules**
    - A rule requiring public companies to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the public company
    - A rule requiring national securities exchanges to bar from listing companies that do not create and disclose policies for the recovery of incentive-based compensation received in excess of what would have been received under an accounting restatement

Environmental, Social and Governance (“ESG”) Shareholder Proposals

- ESG criteria are a set of standards that socially conscious investors use in evaluating investment decisions and the operations of companies in which they own stock
  - Environmental and social shareholder proposal topics that were common in 2018 include board diversity and companies' relationship to, climate change, political activity, human rights and sexual misconduct
  - Governance proposals, the most common of ESG shareholder proposals, in 2018 largely included calling special meetings of shareholders, shareholders acting by written consent, proxy access and maintaining an independent board chair
  - SEC Chairman Clayton cited cybersecurity and related disclosure as becoming an important topic in ESG
- Some large funds have recently indicated that ESG concerns will be a priority in public companies in which they own shares
  - BlackRock Chairman and CEO stated that his firm, the world's largest asset manager, intends to become a global leader in sustainable investing
    - BlackRock launched several funds that incorporate ESG criteria into their investment decisions
  - ISS stated that it will begin to include environmental and social scores, together with its current governance scores, in reports it sends to investors
    - However, ISS has indicated these scores will not affect its proxy voting recommendations
- The US Department of Labor issued guidance that while ESG factors may be considered in investment choices of regulated retirement account fiduciaries, economic interests must come first

ESG Shareholder Proposals

- In October 2018, a large group of institutional investors, asset managers, state treasurers and ESG advocates submitted a petition to the SEC to mandate standardized disclosure of ESG
  - Around two dozen other countries and seven exchanges require some form of ESG disclosure
  - Investors have noted concerns that ESG disclosure is inconsistent, hard to compare across businesses and easy to game by companies cherry-picking data
  - The petition argues that ESG standards fall within the SEC's jurisdiction as promoting efficiency and competition in US capital formation
  - The petition suggests as a guide the Financial Stability Board's Task Force on Climate-Related Financial Disclosure (June 2017)
- SEC Chairman Clayton acknowledged the growing demand for ESG disclosure standardization at the SEC's Investor Advisory Committee meeting in December 2018
  - However, Clayton noted that market-developed ESG frameworks are more analogous to non-GAAP financial measures, are not required in order to comply with SEC rules, a framework may not fit the circumstances of each company or industry and asset managers should not put their preferred ESG topics ahead of their investors' interests
  - Director Hinman has cautioned that he views ESG regulation as premature because the marketplace needs more time to experiment with the type and level of disclosure that are material and useful to investors
  - The SEC is concerned that there may not be comparable and accurate disclosure by ESG funds in non-US markets without strong enforcement and private remedies

Competition between US Trading Venues and the Role of MEMX

Exchanges: Access to Data and Pricing

MEMX

- **What is MEMX?**
  - In January 2019, nine of the largest participants in daily U.S. trading announced that they are joining forces to create the Members Exchange (“MEMX”)
    - BofA, Charles Schwabb, Citadel Securities, E*Trade, Fidelity Investments, Morgan Stanley, TD Ameritrade, UBS, and Virtu Financial
    - MEMX will be controlled by its nine founders, not publically traded like other large exchanges
    - Virtu Financial and Citadel Securities alone represent approximately 40% of daily US trading flow
  - Details about the exchange’s business model remain open
    - Management team still being finalized
    - MEMX submitted its application for registration as an exchange with the SEC in early 2019
- **Why has MEMX been proposed?**
  - Brokers and traders have voiced concern about what they view as unjustifiably high fees for proprietary market data products
  - SIFMA contends that members were charged 2,900 times more than in 2010 for the same data
  - The SEC ruled for the first time in October 2018 the NYSE and Nasdaq did not justify fee increases
    - The SEC dismissed arguments by the exchanges that prices were constrained by algorithmic traders who could easily move to another exchange if the costs were set too high
    - However, the SEC also remanded a further 400 challenges by SIFMA and Bloomberg back to the exchanges for reconsideration

Exchanges: Access to Data and Pricing

MEMX

- **What happened last time a major new exchange was proposed?**
  - ***Consolidation: BATS***
    - BATS, formed in 2009 by a collection of large financial institutions and high-frequency traders, used new technology and pricing strategies to gain a significant market share of equity exchanges
    - BATS was acquired by CBOE in 2016, a reversal of the previous decade's market fragmentation
  - ***Legal Challenge: IEX***
    - Rival exchanges filed legal challenges relating to IEX's "speed bump" provision, which slowed trading by 350 microseconds, delaying IEX's SEC approval by two years
    - MEMX has ruled out a speed bump
    - The Chairman and CEO of ICE (which owns NYSE) has stated that ICE will not challenge the MEMX application
  - ***Regulatory Hurdles: Long-Term Stock Exchange ("LTSE")***
    - LTSE is a proposed exchange founded with the aim of providing startups greater flexibility in long-term planning
      - Rules would bind listed companies to stricter corporate governance standards, including a provision that shareholders' voting power increases the longer they hold stock
    - SEC Commissioner Robert Jackson questioned the voting rule, concerned that it could leave management and founders unaccountable to shareholders
    - LTSE's SEC application is still pending; it withdrew its application in August 2018 but resubmitted later that year

Exchanges: Transaction Fee and Rebate Structures

SEC's Transaction Fee Pilot

- The SEC announced the adoption of a new rule that would implement a pilot program at all equities exchanges designed to study the effects that exchange transaction fee and rebate pricing models have on order routing behavior, execution quality and market quality
  - Data from the pilot program was to facilitate an empirical evaluation transaction-based fee and rebate structures help or hinder markets, and what, if any, the regulatory response should be
  - The pilot program would have included three test groups, each with 1,000 securities, each using different fee structures
- The predominant fee model in equities exchanges is the "Maker-Taker" model, in which an exchange pays a broker-dealer a per-share rebate to provide liquidity in securities (the "make") and charges them a fee for accessing bids and offers (the "take")
  - Supporters argue the system increases liquidity; opponents believe it creates conflicts of interests for brokers who use exchanges they benefit the most from, causing less competition and higher fees to end-users
- In March 2019, the SEC voluntarily delayed the program pending a decision by the courts after Nasdaq and CBOE sued the SEC, claiming the pilot program is arbitrary and capricious and that it exceeds the SEC's authority

SEC Response to MiFID II Research Rules

The SEC's Response to MiFID II Research Rules

- Under MiFID II, research reports need to be explicitly priced and separated from execution costs
  - Research costs cannot be linked to either the volume or value of transactions executed by the broker
  - The rules were designed to reduce inducements and conflicts of interest – many banks and brokers historically provided research for free as a way to lure fund managers to trade with them
  - The rules are in tension with US practices and raise significant US legal issues for advisers and brokers
- The US legal response to MiFID II is still evolving
  - The SEC staff released a statement in December 2018 that it will continue to monitor how MiFID II's research provisions are affecting broker-dealers; investors; and small, medium and large issuers
  - The staff has made no decision or change in policy, but will continue to evaluate possible recommendations
  - The staff will continue to conduct industry outreach and engage with European authorities
- US Market response to MiFID II
  - A recent survey of buy-side firms concluded that 87% of such firms expect to be impacted by MiFID II in 2018
  - SIFMA submitted a comment letter to the SEC requesting permanent relief to allow broker-dealers to charge separately for research without being deemed investment advisers subject to the Investment Advisers Act
  - Some firms have decided to pay the cost of research themselves (Janus: 2018 MiFID costs estimated at $19 million; Man Group: 2018 MiFID costs estimated between $10-15 million)
  - SEC concern: analysts may have less incentive to follow smaller public companies if research is not supported by trading fees

The SEC's Response to MiFID II Research Rules

- The SEC staff has issued several no-action letters on the topic meant to provide companies a path to comply with the MiFID II research requirements in a manner consistent with US securities laws
  - No-Action: Broker-dealers may receive research payments from money managers in cash or from MiFID-governed advisory clients' research payment accounts from MiFID-affected clients without being considered investment advisers
    - The No-Action Letter expires on July 3, 2020
  - No-Action: Money managers may continue to aggregate client orders for purchases and sales of securities, where some clients may pay different amounts for research due to MiFID II requirements, as long as all clients continue to receive the same average price for the security and execution costs
  - No-Action: Money managers may continue to rely on an existing safe harbor, when paying broker-dealers for research and brokerage, that they will not breach their fiduciary duties
    - Money manager in the US often use client commission arrangements to obtain brokerage and research services from a broker-dealer using a single, bundled commission

Modernization, Simplification and Frequency of Disclosure

Other SEC Regulatory Updates and Priorities

Modernization, Simplification and Frequency of Disclosure

- **FAST Act**: The SEC approved a rule on March 20, 2019 to implement provisions of the Fixing America's Surface Transportation Act ("FAST Act") to modernize and simplify disclosure requirements for public companies
  - Selected amendments to Regulation S-K and related forms:
    - Allows registrants to redact certain non-material information that would put it at a competitive disadvantage if disclosed without having to file a separate confidential treatment request
    - Increases flexibility in how management discusses historical performance of the company
      - Strict year-to-year comparisons no longer required; registrants may present the information in any form that enhances a reader's understanding of the registrant's financial condition, changes in financial condition and results of operations
      - Discussion of the earliest of the three years provided in financial statements may be omitted in certain circumstances where the information has already been disclosed in prior filings
    - Incorporates enhanced technology into the SEC's filing system to allow ease of data collection and cross-references
    - Several other consolidated and streamlined disclosure requirements on corporate governance and details about a particular offering
- **Quarterly Reporting**: The SEC requested public comment on potential changes to quarterly reporting
  - The SEC sought comment on how existing periodic reporting requirements may foster an overly short-term focus by managers and other market participants
  - Select questions:
    - Whether earnings releases can satisfy the core requirements of periodic financial disclosure
    - Should all public companies, or only certain classes, be given flexibility as to the frequency of their reporting
    - How do the current periodic reporting requirements affect corporate decision making and strategic thinking
    - Where do the nature and timing of quarterly reports overlap with voluntary disclosures on Form 8-K

Other SEC Regulatory Updates and Priorities

- **"Best Interest" Rule/Fiduciary Standards**
  - The SEC anticipates finalizing rules related to the standards for broker-dealers to act in the best interests of their clients and an interpretation of federal fiduciary standards for investment advisers
- **Brexit Disclosure**
  - Director Hinman gave a recent speech discussing the questions US-regulated companies should consider in drafting Brexit disclosure, which should be tailored to the company
    - Is the company exposed to regulatory risk given uncertainty of which laws will apply and does it have transition arrangements
    - Are their significant supply-chain risks due to potential disruption of the UK's access to free trade agreements
    - Does the company face a material risk of losing customers
    - Does the company have material exposure to currency devaluation or foreign currency exchange rate risk
    - What is the company's contractual risk due to Brexit
- **Brexit Memoranda of Understanding Between the SEC and the UK's Financial Conduct Authority – March 29, 2019 (Effective Only If Brexit Occurs)**
  - MOU originally entered in 2006: Comprehensive supervisory arrangement covering regulated entities operating across borders
    - Updated to expand the scope of firms covered to reflect (i) post-financial crisis reforms related to derivatives and (ii) the FCA's assumption of responsibility from the European Securities and Market Authority for overseeing credit rating agencies and trade repositories in the event of Brexit
  - MOU originally entered in 2013: Framework for supervisory cooperation and exchange of information on entities in the alternative investment fund industry
    - Updated to ensure regulated entities in the alternative fund industry can operate on a cross border basis without interruption

SEC & CFTC Recent Enforcement Updates

Extraterritorial Application of US Securities Laws

SEC v. Scoville (Jan. 2019)

- 10th Circuit held that the SEC can bring fraud claims relating to certain foreign transactions as the Dodd-Frank Act ("DFA") abrogated part of the US Supreme Court's ruling in *Morrison v. National Australia Bank Ltd.* ("*Morrison*")
- **History of extraterritorial application of the antifraud provisions of the US securities laws**
  - ***Pre-Morrison***: The SEC traditionally applied the "Conduct-and-Effect" test: Antifraud provisions applied if the *wrongful conduct* (a) occurred in the US or (b) had a substantial effect in the US
  - ***Morrison***: Replaced this extraterritorial application with a transactional test, holding that the anti-fraud provisions only apply to the purchase and sale of (x) US-exchange listed securities or (y) other securities in the US
  - ***DFA***: §929P(b) provides district courts with jurisdiction over the antifraud provisions of the securities laws in matters brought by the SEC or DOJ as long as the conduct-and-effects test has been satisfied
    - *Morrison* decided on the last day that the Congressional committee reconciling the House and Senate versions of DFA met
- **Ruling**
  - ***Majority***: Although *Morrison* addressed the scope of the antifraud provisions and DFA addressed US courts' jurisdiction, Congress would have been unaware of the Morrison ruling. Congress appeared in DFA to believe it was extending the antifraud provisions extraterritorially. The conduct-and-effect test is thus reinstated as to SEC actions
  - ***Concurrence***: The antifraud provisions would still apply under the test as set forth in *Morrison* and its progeny and the question of whether DFA abrogated parts of *Morison* is not necessary
- **Takeaways**
  - Strong precedent for more SEC fraud cases against foreign transactions but unclear how the Supreme Court will interpret the matter
  - Other federal courts, particularly the 2nd Circuit, have built out *Morrison*, clarifying its application to swaps, ADRs, unregistered exchanges, and foreign securities cross-listed in the US
  - At least one recent study has found that *Morrison* has not substantially changed the type of litigation brought against foreign issuers

Officer Communications/Social Media Postings

SEC v. Tesla, Inc. (Sept. 2018)

- The SEC commenced actions against Tesla and its CEO and Chairman Elon Musk relating to allegedly materially misleading tweets by Musk about taking the company private
  - ***Settlements with Tesla and Musk***
    - $20 million penalty imposed on both Tesla and Musk
    - Musk separately agreed to step down as Chairman of the board for three years
    - Agreed to strengthen governance controls, including a requirement to add two new independent directors and retaining an experienced securities laws lawyer
    - Agreed to implement controls to oversee all of Musk's communications about the company and must pre-approve any such written communications that could reasonably contain material information about the company
- **Takeaways**
  - Represents SEC's new focus on crafting individualized settlements for a particular violation and not punishing shareholders for certain actions of management (no antifraud charges were imputed to Tesla)
  - Companies may need to focus on putting guardrails around officers, especially regarding social media postings
    - SEC's charge: Tesla failed to maintain disclosure control procedures – it should have realized additional discipline required to ensure Musk's compliance with disclosure laws given his past conduct and unusual prominence on social media
- **Contempt Proceedings**
  - In March of 2019, the SEC asked a court to hold Musk in contempt of his settlement order relating to a tweet about Tesla's slated production numbers for 2019. It remains to be seen if further actions will be brought against Tesla for failing to prevent Musk's latest statements

Securities Fraud in Silicon Valley

SEC v. Elizabeth Holmes and Theranos, Inc. (March 2018)

- The SEC settled with Theranos and its founder, Elizabeth Holmes, over the raising of $700 million through fraud in which they made exaggerated or false statements about the company's proprietary blood testing technology, business and financial performance
- **Background**
  - Founded in 2003, Theranos marketed a portable blood analyzer that it claimed could conduct over 200 laboratory tests using only a small drop of blood
  - Theranos attracted significant publicity, investments by wealth patrons (including, Rupert Murdoch), and a distinguished board of directors (including former US Secretary of State George Shultz)
  - Holmes asserted Theranos would earn over $100 million in revenue in 2014; she became Silicon Valley's first female billionaire
- **SEC's Claims**
  - In reality, Theranos' product did not work as promised – capable of performing only 12 laboratory tests using industry standard analyzers manufactured by others – and the business brought in only $100,000 in revenue
  - Holmes and Theranos repeatedly and knowingly deceived investors through false and misleading statements in investor presentations, product demonstrations, and media articles
- **Settlement, Charges, and Takeaways**
  - Holmes settled with the SEC, agreeing to pay $500,000 in penalties, be barred from serving as an officer in a public company for 10 years, relinquished control of the company
  - The SEC is pursuing litigation against the company's president
  - Holmes was subsequently indicted on criminal charges; the case is currently proceeding

Antifraud Liability under the Securities Laws

Lorenzo v. SEC (March 2019)

- The US Supreme Court ruled that a defendant who disseminates the material misstatements of another can still be liable under Securities and Exchange Act § 10(b) and SEC Rule 10b-5
- **Background and Facts**
  - The Court held in *Janus Capital Group, Inc. v. First Derivative Traders* ("*Janus*") that liability under Rule 10b-5(b), which prohibits materially misleading statements or omissions, requires that the defendant actually "made" the statement in question (e.g. was the person with ultimate authority over the statement, including its content and dissemination)
  - Defendant Francis Lorenzo, at the direction of his manager, sent two emails to investors that his manager had drafted and that Lorenzo knew contained material misstatements
- **Ruling**
  - The Court held that Lorenzo still faced liability under Rules 10b-5(a) ("employ[ing] any device . . . to defraud") or 10b-5(c) ("engag[ing] in any act, practice, or course of business which operates as a fraud . . .")
  - *Janus* did not preclude Rules 10b-5(a) or (c) from covering liability for material misstatements
- **Takeaways**
  - The Court acknowledged that the ruling could pose potential problems relating to the scope of 10b-5 liability that would require limiting its scope
    - However, the facts here did not present a "borderline case"
  - Future defendants will likely try to distinguish the facts of their cases, arguing their involvement is more tangential

Constitutionality of Administrative Law Judges

Lucia v. SEC (June 2018)

- The US Supreme Court ruled that Administrative Law Judges ("ALJs") are "inferior officers" of the US, not mere employees of the SEC, and as such the Constitution requires they be appointed by the President, "Courts of Law" or "Heads of Departments"
- **Background**
  - The SEC typically has discretion to file enforcement matters in either federal district court or in administrative procedures before an ALJ
  - DFA expanded the scope of cases that can be brought before ALJs
  - ALJ proceedings have significantly less restrictive procedural requirements than federal courts
- **Ruling**
  - ALJs exercise "significant authority" pursuant to the laws of the US: take testimony, conduct trials, rule on admissibility of evidence, enforce compliance with discovery orders, can punish contemptuous conduct, etc.
  - ALJs thus must be appointed pursuant to the Constitution's Appointment Clause
- **Takeaways**
  - Significant legal questions remain, which may dissuade the SEC from bringing cases before ALJs:
    - Does the Commission's (as department head) attempted fix of retroactively ratifying the appointment of the SEC's ALJs suffice?
    - Do the statutory provisions holding that ALJs can only be removed "for cause" improperly insulate them from presidential oversight under prior Supreme Court precedent?
    - What is considered a timely raising of the appointment clause challenge in pending cases?
  - DoJ Guidance extends *Lucia* to ALJs more broadly, not merely ALJs overseeing adversarial proceedings

Market Manipulation

CFTC v. Wilson (Nov. 2018)

- US District Court for the SDNY held that "artificial" prices, for purposes of establishing market manipulation, cannot be proven by only a showing that a market participant structured bids in a manner intended to affect settlement price
- **Facts**
  - Defendant established a long position in illiquid IRS contracts that it believed were undervalued, entering trades slightly above the rate for comparable OTC swaps and received variation margin as the settlement price calculated by the clearinghouse increased
  - Defendant continued to submit higher bids, but ones it still believed were below the FMV of the contract
    - Made 2,895 bids, 61% of which were made in the last 15 minute period of a trading day – the period in which the settlement price was calculated by the clearing house – none of which were consummated
- **Ruling**
  - Manipulation under the Commodity Exchange Act ("CEA"): (1) defendant possessed the ability to influence market prices, (2) an artificial price existed, (3) defendant caused the artificial price and (4) defendant specifically intended to cause the artificial price
  - Court: "Artificial" means not reflecting the basic forces of supply and demand; merely affecting the price is insufficient to demonstrate artificiality – defendant's practice here more closely resembles price discovery
    - Defendant submitted ample evidence as to the true FMV of the contract, never made a bid that it believed was above that, and was prepared to honor any bid that was accepted
    - Even defendant's practice of "banging the close" (submitting a high volume of bids just before closing) is not at issue because the price was still below the true market value
- **Takeaways**
  - First significant case to reject the CFTC's recent broadly expansive view of market manipulation
  - Other amendments to the CEA by DFA may provide alternative routes – Transacting large volumes in a very short time may represent:
    - A "manipulative device" under CEA §6(c)(1) and CFTC Rule 190.1 (*see* the London Whale case)
    - Intentional or reckless disregard for orderly execution of transactions during a closing period under CEA §4c(a)(5)(B)