Annual Review of Federal Securities Regulation

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

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* The following individuals contributed to this survey: Jay H. Knight, chair, is a member of the District of Columbia and Tennessee bars and a partner in the Corporate & Securities Group at Bass, Berry & Sims PLC in Nashville, TN; William N. Lay is a member of the Tennessee bar and an associate at Bass, Berry & Sims PLC in Nashville, TN; Janet A. Spreen is a member of the Ohio and Massachusetts bars and a partner at BakerHostetler in Cleveland, OH; Bonnie C. McNee is a member of the Ohio bar and an associate at BakerHostetler in Cleveland, OH; Linda L. Griggs is a member of the District of Columbia bar and is a senior counsel at Morgan, Lewis & Bockius LLP; Sean M. Donahue is a member of the District of Columbia and New York bars and a partner at Morgan, Lewis & Bockius LLP in Washington, DC; and William O. Fisher is a member of the California bar, a visiting professor at the University of Nebraska College of Law, a former professor at the University of Richmond School of Law, and a former partner of Pillsbury Winthrop LLP in San Francisco, CA.

Introduction

This Annual Review ("Review") was prepared by the Subcommittee on Annual Review of the Committee on Federal Regulation of Securities of the ABA Business Law Section. The Review covers significant developments in federal securities law and regulation during 2017. The Review is divided into three sections: regulatory actions, accounting statements, and caselaw developments. The Review is written from the perspective of practitioners in the fields of corporate and securities law. This results in an emphasis on significant developments under the federal securities laws relating to companies, shareholders, and their respective counsel. Our discussion is limited to those developments that are of greatest interest to a wide range of practitioners and addresses only final rules.

During 2017, the U.S. Securities and Exchange Commission (the "Commission") continued its efforts to facilitate investor access to securities filings and exhibits by adopting final rules requiring registrants that file registration statements and reports subject to the exhibit requirements under Item 601 of Regulation S-K, or that file Forms F-10 or 20-F, to include a hyperlink to each exhibit listed in the exhibit index of such filings.[1] For such hyperlinks to be included, registrants are also now required to submit all such filings in HTML format, absent certain exceptions.[2] By requiring registrants to hyperlink the exhibit index to filed exhibits, the Commission hopes to improve investors' access to the exhibits filed by registrants on EDGAR.[3]

Generally, the Review does not discuss rules or cases that are narrowly focused. For example, the Review does not address hedge fund and other private-fund related rulemaking, nor rulemaking related to registered investment companies, registered investment advisers, or municipal advisors. Cases are chosen for both their legal concepts as well as factual background. While the Subcommittee tries to avoid making editorial comments regarding regulations, rules, or cases, we have attempted to provide a practical analysis of the impact of the developments in the law and regulations on the day-to-day practice of securities lawyers.

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1. Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. 14130 (Mar. 17, 2017) (to be codified at 17 C.F.R. pts. 229, 232, 239 & 249).
2. *Id.* at 14130.
3. *Id*. at 14131.

Regulatory Developments 2017

On March 1, 2017, the U.S. Securities and Exchange Commission (the "Commission") adopted final rules that require registrants that file registration statements and reports subject to the exhibit requirements under Item 601 of Regulation S-K, or that file Forms F-10 or 20-F, to (a) include a hyperlink to each exhibit listed in the exhibit index of these filings, unless the exhibit is filed in paper pursuant to a temporary or continuing hardship exemption under Rules 201[1] or 202[2] of Regulation S-T or pursuant to Rule 311[3] of Regulation S-T, and (b) submit all such filings in HyperText Markup Language ("HTML") format to enable the inclusion of the exhibit hyperlinks.[4]

The rules amended provisions of Item 601 of Regulation S-K,[5] Forms 20-F[6] and F-10,[7] and Rules 11,[8] 102[9] and 105[10] of Regulation S-T.[11] The amendments generally took effect on September 1, 2017; they will take effect on September 1, 2018, for "smaller reporting companies" and other filers that are neither "large accelerated filer[s]" nor "accelerated filer[s]," which submit filings in American Standard Code for Information Interchange ("ASCII").[12] The compliance date for any Form 10-D[13] that will require hyperlinks to any exhibits filed with

1. 17 C.F.R. § 232.201 (2017).
2. *Id.* § 232.202.
3. *Id.* § 232.311.
4. Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. 14130 (Mar. 17, 2017) (to be codified at 17 C.F.R. pts. 229, 232, 239 & 249).
5. 17 C.F.R. § 229.601 (2017). *Compare* Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14141 (amending that rule).
6. *See* 17 C.F.R. § 249.220f (2017). *Compare* Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14143 (amending the instructions to Form 20-F), *with SEC Form 20-F*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/form20-f.pdf (last modified Apr. 2017) (noting OMB expiration date of July 31, 2018).
7. *See* 17 C.F.R. § 239.40 (2017). *Compare* Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14143 (amending the instructions to Form F-10), *with SEC Form F-10*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/formf-10.pdf (last modified Apr. 2009) (noting OMB expiration date of Feb. 28, 2018).
8. 17 C.F.R. § 232.11 (2017). *Compare* Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14142 (amending that rule).
9. 17 C.F.R. § 232.102 (2017). *Compare* Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14142 (amending that rule).
10. 17 C.F.R. § 232.105 (2017). *Compare* Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14142 (amending that rule).
11. 17 C.F.R. §§ 232.10–232.501 (2017).
12. Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14130.
13. *See* 17 C.F.R. § 249.312 (2017); *SEC Form 10-D*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/form10-d.pdf (last modified July 2016) (noting OMB expiration date of Mar. 31, 2018).

Form ABS-EE[14] will be set through a later publication in the Federal Register after the Commission completes programming changes that will allow issuers to include such forms in a single submission, so that the required hyperlinks can be created at the time the Form 10-D is filed.[15]

The goal of the new rules is to facilitate easier access to these exhibits for investors and other users of the information.[16] Under the preexisting rules, once an exhibit is filed, registrants can incorporate it by reference to meet the exhibit requirements in subsequent filings to the extent permitted by any other applicable rules or the disclosure form.[17] Prior to the amendments, accessing an exhibit that had been incorporated by reference required determining the filing in which the exhibit originally appeared, and then locating that filing, which could be a time consuming process.[18] Also, because the ASCII format cannot support functional hyperlinks, registrants will now need to file in HTML format.[19]

The proposed rules and related form amendments were issued on August 31, 2016, and received overwhelming support from commenters.[20] The rules were adopted substantially as proposed, with a few exceptions as noted below.[21]

EXHIBIT HYPERLINKING

As proposed, the final rules exclude XBRL exhibits and exhibits that are filed with Form ABS-EE.[22] Form ABS-EE does not permit exhibits to be incorporated by reference and is used solely to facilitate the filing of tagged data and related information that must be filed as exhibits to that form.[23]

Considering responses to its request for comment, the Commission decided not to extend the rules to apply to Form 6-K[24] filed by foreign private issuers or other multi-jurisdictional disclosure system forms used by certain Canadian issuers, such as Forms F-7,[25] F-8,[26] and F-80,[27] because neither an exhibit nor an exhibit index is required for these forms.[28]

14. *See* 17 C.F.R. § 249.1401 (2017); *SEC Form ABS-EE*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/files/formabs-ee.pdf (last modified Nov. 2014) (noting OMB expiration date of Mar. 31, 2018).

15. Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14130–31.

16. *Id.* at 14131.

17. *Id.*

18. *Id.*

19. *Id.* at 14135.

20. *Id.* at 14131.

21. *Id.*

22. *Id.* at 14133.

23. *Id.* at 14132–33.

24. *See* 17 C.F.R. § 249.306 (2017); *SEC Form 6-K*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/files/form6-k.pdf (last modified Apr. 2009) (noting OMB expiration date of Aug. 31, 2020).

25. *See* 17 C.F.R. § 239.37 (2017); *SEC Form F-7*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/files/formf-7.pdf (last modified Jan. 2007) (noting OMB expiration date of Aug. 31, 2019).

26. *See* 17 C.F.R. § 239.38 (2017); *SEC Form F-8*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/files/formf-8.pdf (last modified Jan. 2007) (noting OMB expiration date of July 31, 2019).

27. *See* 17 C.F.R. § 239.41 (2017); *SEC Form F-80*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/files/formf-80.pdf (last modified Jan. 2007) (noting OMB expiration date of Mar. 31, 2019).

28. Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14132–33.

With respect to registration statement exhibits, the proposed rules would have required registrants to include an active hyperlink to each exhibit only in the version of the registration statement that became effective in order to provide one location for finding the most complete exhibit index and related hyperlinks.[29] However, the Commission was persuaded by commenters that exhibit hyperlinks in the initial registration statement and each subsequent pre-effective amendment would be useful, as investors consider their investment decisions before the filing becomes effective.[30] As a result, the final rules require that each exhibit listed in the exhibit index (other than exhibits filed with Form ABS-EE or an exhibit filed in XBRL) must include an active link to an exhibit that is filed with the registration statement or to the exhibit separately filed on EDGAR.[31]

The Commission also considered responses to its request for comment on whether it should require exhibits that were previously filed only in paper form to be refiled electronically, so that they could also be hyperlinked.[32] Some commenters suggested that refiling be voluntary or required only for the registrant's organizational documents. However, the Commission thought this would only have a limited benefit due to the small number of registrants who have not filed such documents electronically and chose not to impose these additional compliance burdens.[33]

HTML Filing Format

Under the prior rules, registrants could file in either the ASCII or HTML format.[34] However, as noted above, ASCII format does not support hyperlinks, so filing in HTML format is necessary to comply with the required hyperlinking of exhibits.[35]

Commenters supported the HTML filing requirement, but suggested a phase-in or transition period for those still filing in ASCII.[36] Other comments raised concerns regarding potential liability for hyperlinks that are automatically created by software programs and inaccurate or inactive hyperlinks, as well as the need and process for amending filings to correct these errors.[37]

The final rules require HTML filing only for registration statements and reports that are subject to the exhibit filing requirements under Item 601 of Regulation S-K, and registrants can still use ASCII for any schedules or forms that do not have such exhibit requirements, such as proxy statements.[38] Non-accelerated

29. *Id.* at 14132.
30. *Id.* at 14133.
31. *Id.*
32. *Id.* at 14132.
33. *Id.* at 14133.
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.* at 14133–34.
38. *Id.* at 14134.

filers and smaller reporting companies were provided with a one-year phase-in period to help mitigate the cost burdens of switching to HTML format.[39]

The final rule release explained that, with respect to the hyperlinks required to be included in the exhibit index for an exhibit that is filed for the first time, such hyperlinks are to link to the location of that exhibit within the same filing.[40] In addition, the Commission would update the EDGAR Filer Manual to describe the procedures for hyperlinks within a filing and to previously filed documents. The updated manual was released on September 13, 2017.[41]

In response to concerns from commenters regarding filings that contain hyperlink errors, an instruction was added to Rule 105 requiring registrants to update incorrect and nonfunctioning hyperlinks by filing (a) a pre-effective amendment to any such registration statement, or (b) in the case of an effective registration statement or an Exchange Act report, in the next Exchange Act periodic report that requires or includes an exhibit pursuant to Item 601 of Regulation S-K (or Form 20-F or Form F-10 in the case of a foreign private issuer) or, alternatively, a voluntary post-effective amendment to the registration statement.[42]

Rule 105 continues to permit the inclusion of hyperlinks in filings (not just in the exhibit index) to other documents within the same filing or that were previously filed on EDGAR.[43] Rule 105 does not permit hyperlinking to websites, locations, or other documents that are outside of the EDGAR system.[44] The final rules also provide that, if a filer includes an external hyperlink, the linked information will not be considered part of the document for determining compliance with reporting obligations, but the inclusion of the link will subject the filer to the civil liability and antifraud provisions of the federal securities laws with reference to the information contained in the linked material.[45]

Concerns raised by commenters regarding the additional liability that may arise as a result of the mandatory hyperlinking requirements mainly related to content on external websites, which could not be linked under either the pre-existing or new rules.[46] Therefore, the Commission did not feel that any changes were necessary to the liability provisions at this time, but indicated in the final rule release that it would be mindful of these concerns as it continues to consider the expanded use of hyperlinks in Commission filings.[47] The final rule release also noted that an "inaccurate hyperlink alone would not render the filing materially deficient, nor affect a registrant's eligibility to use short-form registration statements."[48]

39. *Id.*
40. *Id.*
41. *See* Adoption of Updated EDGAR Filer Manual, 82 Fed. Reg. 45434, 45436 (Sept. 29, 2017) (to be codified at 17 C.F.R. pt. 232).
42. Exhibit Hyperlinks and HTML Format, 82 Fed. Reg. at 14142.
43. *See id.* at 14134.
44. *Id.*
45. *Id.* at 14142.
46. *Id.* at 14134.
47. *Id.*
48. *Id.*

Accounting Developments 2017

In 2017, the Financial Accounting Standards Board (the "FASB") issued fifteen Accounting Standards Updates ("ASUs") to its Accounting Standards Codification ("ASC" or the "Codification"), as compared to twenty ASUs in 2016. Of the fifteen 2017 ASUs, the FASB issued five ASUs to simplify or make targeted improvements to the related standards, three ASUs to clarify the related standards, including one that clarified the revenue recognition standard adopted in 2014,[1] codified in ASC Topic 606, Revenue from Contracts with Customers ("ASC Topic 606"), three ASUs to reflect the views of staff (the "SEC Staff") of the U.S. Securities and Exchange Commission ("SEC"), two ASUs that articulate consensuses of the FASB's Emerging Issues Task Force (the "EITF"), one ASU to eliminate obsolete guidance and one ASU related to not-for-profit entities. In 2016, the FASB issued twenty ASUs, including three that represented major standard-setting projects, six ASUs that clarified or adopted technical corrections and improvements to ASC Topic 606, three ASUs that simplified existing standards, five ASUs that were consensuses of the FASB's EITF, and one ASU that was a consensus of the FASB's Private Company Council (the "PCC").

The EITF, which was formed in 1984, seeks to address emerging accounting issues before divergent approaches to those issues become widespread.[2] The FASB must approve all consensuses reached by the EITF.[3] The EITF is chaired by the FASB's technical director, has members from the auditing profession and from the preparer and financial statement user communities, and observers from the FASB, the SEC, the Financial Reporting Executive Committee of the American Institute of Certified Accountants (the "AICPA"), and the International Accounting Standards Board.

The PCC was formed by the Board of Trustees of the Financial Accounting Foundation (the "FAF") in May 2012 to determine whether exceptions or modifications to United States generally accepted accounting principles ("GAAP"), including ASUs being considered by the FASB, are appropriate to address the needs of users of private company financial statements.[4] The FASB must endorse all consensuses reached by the PCC.[5] Similar to the EITF, the members of the

1. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) (May 2014) [hereinafter ASU 2014-09].

2. *About the EITF*, Fin. Acct. Standards Board, http://www.fasb.org/eitf/about_eitf.shtml (last visited Apr. 7, 2018).

3. *Id.*

4. Fin. Accounting Found. Bd. of Trs., Establishment of the Private Council: Final Report 2 (May 30, 2012), http://www.accountingfoundation.org/cs/ContentServer?c=Document_C&cid=1176160066778&d=&pagename=Foundation%2FDocument_C%2FFAFDocumentPage.

5. *Id.*

PCC are from the auditing profession and from the preparer and financial statement user communities with significant experience conducting audits or preparing or using private company financial statements.[6] An FASB member is a liaison between the PCC and FASB, and the FASB provides technical and administrative staff to work with the PCC.

The following is a discussion about (a) the ASUs that the FASB issued in 2017 that were not originated by the EITF or the PCC and (b) the ASUs that were originated by the EITF in 2017.

A. ASUs Originated by the FASB

1. Clarifying the Definition of a Business

In January 2017, the FASB issued ASU No. 2017-01,[7] which is intended to address concerns that the definition of a business in ASC Topic 805, Business Combinations ("ASC Topic 805"), was difficult and costly to implement and was being applied too broadly, resulting in asset acquisitions being treated as acquisitions of businesses.[8] These concerns were the primary comments made by stakeholders in connection with the post-implementation review of FASB Statement No. 141 (revised 2007), Business Combinations (Statement 141(R)), which is codified in ASC Topic 805, that was conducted by the FAF, the organization that oversees the FASB.[9] The definition of a business affects the accounting for acquisitions, disposals, goodwill, and consolidation, among other areas of accounting.[10] The FASB expects that the revised definition is more operable and will permit more consistent implementation and reduce compliance costs.[11] Unfortunately for SEC registrants, the revised definition is not the same as the SEC's definition in Article 11 of Regulation S-X.[12]

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6. *Id.*

7. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business (Jan. 2017) [hereinafter ASU 2017-01].

8. *Id.* at 1.

9. Fin. Accounting Found., Post-Implementation Review Report on FASB Statement No. 141 (revised 2007), Business Combinations (Statement 141(R)) (May 2013), http://accountingfoundation.org/cs/ContentServer?c=Document_C&cid=1176162641881&d=&pagename=Foundation%2FDocument_C%2FFAFDocumentPage.

10. ASU 2017-001, *supra* note 7, at 1.

11. *Id.* at 3.

12. Rule 11-01(d) of Regulation S-X defines a business as follows:

> For purposes of this rule, the term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity's operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business. However, a lesser component of an entity may also constitute a business. Among the facts and circumstances which should be considered in evaluating whether an acquisition of a lesser component of an entity constitutes a business are the following:
>
> (1) Whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction; or
>
> (2) Whether any of the following attributes remain with the component after the transaction:
>
> (i) Physical facilities,

ASU 2017-01 clarifies the definition of a business by:

- providing that, if the fair value of the gross assets acquired or disposed of is concentrated in a single identifiable asset or group of similar identifiable assets, such assets are not a business;[13]
- stating that, in other cases, to be a business, an integrated set of assets and activities (collectively referred to as a "set") "must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output";[14]
- narrowing the definition of an output to align it with the definition in Topic 606, Revenue from Contracts with Customers,[15] by defining an output as "[t]he result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues";[16] and
- providing a framework to assist entities in determining whether the set includes both an input, such as "long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees,"[17] and a substantive process, such as "strategic management processes, operational processes, and resource management processes" but not administrative systems.[18]

ASU 2017-01 defines a business as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants."[19] To be considered a business, the set need not actually have outputs. It simply must have

(ii) Employee base,

(iii) Market distribution system,

(iv) Sales force,

(v) Customer base,

(vi) Operating rights,

(vii) Production techniques, or

(viii) Trade names.

17 C.F.R. § 210.11-01(d) (2017).

13. ASU 2017-001, *supra* note 7, at 2.
14. *Id.*
15. *Id.* at 3.
16. *Id.* at 6 (to be codified at ASC 805-10-55-4c).
17. *Id.* (to be codified at ASC 805-10-55-4a).
18. *Id.* at 2, 6 (to be codified at ASC 805-10-55-4b).
19. *Id.* at 6 (to be codified at ASC 805-10-55-3A).

"the inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs."[20]

The framework set forth in ASU 2017-01 provides that, when a set does not have any outputs, such as a company that has not generated any revenues, the set is not a business unless it has employees who "have the necessary skills, knowledge or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs."[21] When a set has outputs, it will constitute a business only when both an input and a substantive process have been acquired, which, together, significantly contribute to the ability to create outputs.[22] Therefore, the mere assumption of contractual arrangements that provide for the continuation of revenues does not mean that a set is a business.[23]

ASU 2017-01 sets forth various examples that illustrate the application of the revised definition of business. Among the examples are (1) the acquisition of a portfolio of ten single-family homes, together with in-place leases, and an office park with six ten-story buildings, together with in-place leases; (2) an acquisition of a drug candidate in which the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets; (3) an acquisition of the shares of a company whose operations include research and development activities on several drug compounds; and (4) the acquisition of a sublicense to distribute yogurt in Latin America, existing customer contracts, and an at-market supply contract with the yogurt producer.[24] There follows a discussion about these examples.

Example 1 is the acquisition of a portfolio of ten single-family homes, together with in-place leases, and an office park with six ten-story buildings, together with in-place leases for all of the office space.[25] In addition, the acquisition includes the vendor contracts for outsourced cleaning, security, and maintenance but none of the seller's employees who perform leasing, tenant management, financing, and other strategic management processes. The acquired assets are not similar because the risks related to the family homes and those related to the office space are very different. Since the acquisition does not include employees and the vendor contracts are for ancillary or minor activities that are easily obtainable in the marketplace, the acquisition does not include both an input and a substantive process that together significantly contribute to the ability to create outputs and is not considered to be the acquisition of a business.

Example 2 is the acquisition of a legal entity that has the rights to a Phase 3 compound being developed to treat diabetes in an in-process research and development project, an at-market clinical research organization contract, and an

20. *Id.* at 6 (to be codified at ASC 805-10-55-4).
21. *Id.* at 8 (to be codified at ASC 805-10-55-5D).
22. *Id.* (to be codified at ASC 805-10-55-5E).
23. *Id.* at 9 (to be codified at ASC 805-10-55-5F).
24. *Id.* at 12–17, 14–15, 11–12, and 16–17.
25. *Id.* at 11–12 (to be codified at ASC 805-10-55-55 through 61).

at-market clinical manufacturing organization contract that has no employees.[26] Since the in-process research and development project is the only asset that has a fair value, the acquisition is not an acquisition of a business because "substantially all of the fair value of the gross assets acquired is concentrated in the single in-process research and development asset."

Example 3 is the acquisition of all of the outstanding shares of a company that has only conducted research and development activities on several drug compounds and, accordingly, has not generated any revenue.[27] The in-process research and development projects are all in different phases and would treat significantly different diseases. The acquired company has employees with the necessary skills, knowledge, or experience to perform research and development activities and has long-lived tangible assets such as a corporate headquarters, a research lab, and lab equipment but has not generated any revenues. The company's assets are not similar because the projects have different development risks, market risks, and customer bases and therefore substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Therefore, the acquisition has to be evaluated to determine whether it includes both an input and a substantive process that together significantly contribute to the ability to create outputs. Since the company has a workforce that can perform processes to develop the in-process research and development inputs, the acquisition is considered to be an acquisition of a business.

Example 4 is the acquisition of a sublicense to distribute yogurt in Latin America, existing customer contracts in Latin America, and an at-market supply contract with the producer of the yogurt, but no employees or distribution capabilities.[28] The identifiable assets in the acquisition are the license and the customer contracts, which have fair values, and the supply agreement. Since the assets are in different major classes of identifiable intangible assets, they are not similar and, therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Nevertheless, the acquired assets are not a business because the acquisition does not include an organized workforce or any acquired processes and does not include both an input and a substantive process.

ASU 2017-01 is effective for public business entities[29] for financial statements for fiscal years, and interim periods within those fiscal years, beginning after

26. *Id.* at 12–13 (to be codified at ASC 805-10-55-65 through 66).
27. *Id.* at 14–15 (to be codified at ASC 805-10-55-70 through 72).
28. *Id.* at 16–17 (to be codified at ASC 805-10-55-82 through 84).
29. The FASB defines the term "public business entity" as follows:

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

December 15, 2017.[30] Other entities must adopt ASU 2017-01 for financial statements for fiscal years beginning after December 15, 2018, and for interim periods within fiscal years beginning after December 15, 2019.[31] The amendments must be applied prospectively and no disclosures are required at transition.[32] Early application is permitted under specified circumstances.[33]

2. Not-for-Profit Entities—Consolidation

In January 2017, the FASB issued ASU No. 2017-02,[34] which clarifies when a not-for-profit entity that is a general partner or a limited partner should consolidate a for-profit limited partnership or similar legal entity once the revised consolidation guidance in ASU No. 2015-02[35] becomes effective.[36] ASU 2015-02 superseded guidance related to partnerships, with the result that not-for-profit entities applying ASU 2015-02 would not have any guidance related to whether they should consolidate a for-profit limited partnership since ASU 2015-02 only provides guidance for when a limited partner should consolidate the partnership.[37] The amendments in ASU 2017-02 maintain the existing consolidation guidance for not-for-profit general partners and adds guidance on when not-

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b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Master Glossary, Accounting Standards Codification, Fin. Acct. Standards Board, https://asc.fasb.org/glossary&letter=P (last visited Feb. 21. 2018) (password protected).

30. ASU 2017-01, *supra* note72, at 3.

31. *Id.*

32. *Id.*

33. *Id.* at 4.

34. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-02, Not-for-Profit Entities—Consolidation: Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity (Jan. 2017) [hereinafter ASU 2017-02].

35. Fin. Accounting Standards Bd., Accounting Standards Update No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis (Feb. 2015) [hereinafter ASU 2015-02].

36. ASU 2017-02, *supra* note 34, at 1.

37. *Id.*

for-profit limited partners should consolidate a limited partnership.[38] ASU 2017-02 also makes clarifying changes to the guidance applicable to fair value elections for not-for-profit entities in ASC Subtopic 958-810, Not-for-Profit Entities ("ASC 958-810").[39]

Under ASU 2017-02, a not-for-profit entity that is a general partner of a for-profit limited partnership will continue to be presumed to control the for-profit limited partnership, regardless of the extent of its ownership interest, unless that presumption is overcome because the limited partners have substantive kick-out rights or substantive participating rights.[40] ASU 2017-02 includes this guidance in ASC 958-810 together with guidance for not-for-profit entities that are limited partners of for-profit limited partnerships on when to consolidate limited partnerships that are not variable interest entities or are not within the scope of the variable interest entity consolidation guidance.[41] Similar guidance on the consolidation of limited partnerships may be found in ASC Subtopic 810-10, Consolidation.[42]

ASU 2017-02 is effective for not-for-profit entities for financial statements for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017.[43] Early adoption is permitted, including in an interim period, provided that any adjustments are reflected as of the beginning of the fiscal year that includes that interim period.[44] Not-for-profit entities that have not adopted the amendments in ASU 2015-02 are required to adopt ASU 2017-02 at the time they adopt the amendments in ASU 2015-02 and use the same transition method they use for their adoption of ASU 2015-02.[45] Not-for-profit entities that have already adopted the amendments in ASU 2015-02 are required to apply the amendments in ASU 2017-02 retrospectively to all relevant prior periods beginning with the fiscal year in which the amendments in ASU 2015-02 initially were applied.[46]

3. SEC Announcements Related to Disclosure About Compliance with New ASUS and About Accounting for Investments in Qualified Affordable Housing Projects

In January 2017, the FASB issued ASU No. 2017-03[47] to amend its guidance related to (1) accounting changes, to add remarks made by a member of the

38. *Id.*
39. *Id.* at 3.
40. *Id.* at 2.
41. *Id.*
42. *Id.*
43. *Id.* at 3.
44. *Id.* at 3–4.
45. *Id.* at 4.
46. *Id.*
47. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-03, Accounting Changes and Error Corrections (Topic 250) and Investments—Equity Method and Joint Ventures (Topic 323): Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings (Jan. 2017) [hereinafter ASU 2017-03].

SEC Staff at the September 22, 2016, meeting of the EITF; and (2) investments in qualified affordable housing projects, to revise the text of a paragraph in the Codification that sets forth the SEC Staff's views on this topic as a result of a remark made by the SEC Staff at the November 17, 2016, meeting of the EITF.[48] In addition, the FASB added references to the codification of the SEC Staff's September 22, 2016, remarks in its guidance related to ASU 2014-09,[49] ASU No. 2016-02, Leases (Topic 326),[50] and ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 36): Measurement of Credit Losses on Financial Instruments.[51]

The SEC Staff's remarks at the September 22, 2016, EITF meeting focused on the disclosure that the SEC Staff expects a company to consider making about the potential material effects on the financial statements of future compliance with the ASUs related to revenue recognition, leases, and credit losses.[52] The SEC Staff's remarks, which are codified at ASC 250-10-S99-6, note the requirement in Topic 11.M of the Codification of Staff Accounting Bulletins that a company evaluate ASUs that have not yet been adopted to determine the appropriate financial statement disclosures about the potential material effects of those ASUs on the financial statements when adopted.[53] With respect to the new ASUs on revenue recognition, leases, and credit losses, the SEC Staff's remarks note that, if a company does not know or cannot reasonably estimate the impact of its compliance with one of those new ASUs, "in addition to making a statement to that effect," the company should "consider additional qualitative financial statements disclosures to assist the reader in assessing the significance of the impact that the standards will have on the financial statements of the registrant when adopted," including "a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies."[54] In addition, the company should describe the status of its implementation process and the significant implementation matters that it still must address.[55]

The SEC Staff's remark at the November 17, 2016, EITF meeting resulted in the FASB's amendment in ASU 2017-03 to ASC 323-740-S99-2, "SEC Observer Comment: Accounting for Tax Benefits Resulting from Investments in Qualified

48. *Id.* at 1, 17.

49. The new revenue recognition provisions are effective for financial statements of public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Fin. Accounting Standards Bd., Accounting Standards Update No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date 1 (Aug. 2015).

50. The new lease provisions are effective for financial statements of public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-02, Leases (Topic 842) 7 (Feb. 2016).

51. The new credit loss provisions are effective for financial statements of public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments 5 (June 2016).

52. ASU 2017-03, *supra* note 47, at 2.

53. *Id.*

54. *Id.*

55. *Id.*

Affordable Housing Projects" (the "SEC Observer Comment").[56] The amended language conforms the SEC Observer Comment to the FASB's guidance on this topic issued in ASU 2014-01[57] by replacing the reference to the effective yield method of accounting with a reference to the proportional amortization method of accounting and stating that a decision to apply the proportional amortization method of accounting must be applied consistently to all investments in qualified affordable housing projects that meet the requisite conditions rather than a decision to be applied to individual investments, among other changes.[58]

4. Simplification of the Test for Goodwill Impairment

In January 2017, the FASB issued ASU No. 2017-04,[59] which is intended to simplify how an entity is required to test goodwill for impairment by eliminating the need for an entity to compare the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill, which is Step 2 of the goodwill impairment test.[60] The FASB undertook this project as a result of its approval in 2014 of an alternative accounting treatment for the subsequent measurement of goodwill by private companies in light of private company concerns about the cost and complexity of the goodwill impairment test.[61]

The amendments in ASU 2017-04 apply to public business entities and other entities that have not elected the private company alternative for the subsequent measurement of goodwill.[62] Any private company that adopted the private company alternative for goodwill but not the private company alternative to subsume certain intangible assets into goodwill is permitted to adopt the amendments in ASU 2017-04 without having to justify the preferability of the accounting change as long as it adopts the amendments in ASU 2017-04 on or before the effective date.[63] Any private company that has adopted the private company alternative to subsume certain intangible assets into goodwill may only adopt the amendments in ASU 2017-04 if it justifies the accounting change in accordance with ASC Topic 250, Accounting Changes and Error Corrections.[64]

As a result of the amendments, an entity will no longer need to calculate the implied fair value of goodwill by assigning the fair value of a reporting unit to all of its assets and liabilities as if that reporting unit had been acquired in a busi-

56. *Id.* at 17–18.
57. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-01, Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (Jan. 2014).
58. ASU 2017-03, *supra* note 47, at 18.
59. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-04, Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment (Jan. 2017) [hereinafter ASU 2017-04].
60. *Id.* at 1.
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*

ness combination, which is Step 2 of the goodwill impairment test.[65] Instead, an entity will simply perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and recognize an impairment in the amount, if any, by which the carrying amount exceeds the reporting unit's fair value.[66] The new guidance also states that the amount of the impairment loss should not exceed the total amount of goodwill allocated to that reporting unit and an entity should consider the income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable.[67]

With respect to a reporting unit with a zero or negative carrying amount, the Board eliminated the requirement that an entity perform a qualitative assessment of such a reporting unit and, if the reporting unit fails that qualitative test, that an entity perform Step 2 of the goodwill impairment test.[68] Instead, the same impairment test applies to all reporting units although an entity must disclose the amount of goodwill allocated to each reporting unit with a zero or negative carrying amount of net assets.[69]

ASU 2017-04 is effective for the annual or any interim goodwill impairment test conducted by a public business entity that is an SEC filer in fiscal years beginning after December 15, 2019, and for any such test conducted by a public business entity that is not an SEC filer in fiscal years beginning after December 15, 2020.[70] All other entities, including not-for-profit entities, that are adopting the amendments should do so for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021.[71] Early adoption is permitted for any goodwill impairment test performed after January 1, 2017.[72] Upon adoption, the amendments must be applied on a prospective basis and an entity must disclose the nature of and reason for the change in accounting principle in the first annual period and in the first interim period within the first annual period when the entity initially adopts the amendments.[73]

5. Asset Derecognition and Partial Sales of Nonfinancial Assets

In February 2017, the FASB issued ASU No. 2017-05,[74] which is intended to clarify the scope of the guidance relating to the derecognition of nonfinancial as-

65. *Id.* at 2.
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.* at 3.
71. *Id.*
72. *Id.*
73. *Id.*
74. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-05, Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets (Feb. 2017) [hereinafter ASU 2017-05].

sets upon a sale to, or other transaction involving such assets with, noncustomers in ASC 610-20, Other Income ("ASC 610-20"), which was adopted in connection with the new revenue recognition guidance in ASU 2014-09, and to add guidance for partial sales of nonfinancial assets.[75] The FASB undertook this project as a result of questions from stakeholders after its adoption of ASU 2014-09 relating to the scope of ASC 610-20 and the accounting for partial sales of nonfinancial assets, including in connection with the formation of joint ventures and in exchange for equity interests.[76]

The industry primarily affected by the amendments in ASU 2017-05 is the real estate industry but entities in other industries, such as the power and utilities, alternative energy, life sciences, and shipping industries, may also be affected.[77] The amendments, which do not apply to transfers of businesses or nonprofit activities, affect the following types of entities:

- "[a]n entity that enters into a contract to transfer to a noncustomer a nonfinancial asset, a group of nonfinancial assets, or an ownership interest in a consolidated subsidiary that is not a business or nonprofit activity";
- "[a]n entity that historically had transactions within the scope of the real estate-specific derecognition guidance"; and
- "[a]n entity that contributes nonfinancial assets that are not a business or a nonprofit activity to a joint venture or other noncontrolled investee."[78]

The amendments clarify when a financial asset and when nonfinancial assets transferred within a legal entity are within the scope of ASC 610-20.[79] Any financial assets transferred to a counterparty are considered to be in substance nonfinancial assets, and therefore within the scope of ASC 610-20, "if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets."[80] In addition, a contract that includes the transfer of ownership interests in one or more consolidated subsidiaries will be regarded as within the scope of ASC 610-20 when the fair value of all of the assets that are promised to the counterparty in the contract is concentrated in nonfinancial assets.[81] A contract that involves the transfer of assets that are not concentrated in nonfinancial assets but also includes some assets in an individual consolidated subsidiary will require the treatment of assets within the individual consolidated subsidiary as in substance nonfinancial assets within the scope of ASC 610-20 "if substantially all the fair value of the assets (recognized and unrecognized) that are promised to

75. *Id.* at 1.
76. *Id.* at 58–59, 1.
77. *Id.* at 4.
78. *Id.* at 2–3.
79. *Id.* at 2.
80. *Id.*
81. *Id.*

the counterparty in that subsidiary is concentrated in nonfinancial assets."[82] ASU 2017-05 also eliminated the requirement that any transfer of an equity method investment must be accounted for in accordance with the guidance in ASC Topic 860, Transfers and Servicing, unless the equity method investment is considered to be an in substance nonfinancial asset.[83]

With respect to partial sales, ASU 2017-05 provides that a partial sale of a nonfinancial asset or an in substance nonfinancial asset, including contributions of such assets to a joint venture or other noncontrolled investee, must be accounted for as a derecognition of the asset when the entity "(1) does not have (or ceases to have) a controlling financial interest in the legal entity that holds the asset in accordance with Topic 810 and (2) transfers control of the asset in accordance with Topic 606."[84] Upon such a transfer, the entity must value any noncontrolling interest it receives (or retains) at fair value.[85] When the entity retains a controlling financial interest in a consolidated subsidiary after a transfer of ownership interests in that subsidiary, it must account for the transaction as an equity transaction in which no gain or loss is recognized, which precludes the derecognition of the assets and liabilities of the subsidiary.[86]

ASU 2017-05 simplifies GAAP by eliminating the requirement that an entity consider whether a business or nonprofit activity or an equity method investment is also in substance real estate or an in substance nonfinancial asset,[87] by eliminating several accounting differences between transactions involving assets and transactions involving businesses and by eliminating the need to distinguish between a joint venture and other types of investees.[88] An example of the accounting differences that have been eliminated relates to the valuation of a retained noncontrolling interest. The measurement of a retained noncontrolling interest in a nonfinancial asset will be required to be at fair value, consistent with the measurement of a retained noncontrolling interest in a business, rather than at the carryover basis as required under current GAAP.[89]

ASU 2017-05 is effective at the same time as the revenue recognition provisions in ASC Topic 606.[90] That is, for public business entities (except as set forth in ASU 2017-13, which is discussed below), the amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017.[91] Other entities must adopt ASU 2017-05 for financial statements for fiscal years beginning after December 15, 2018, and for interim periods within fiscal years beginning after December 15, 2019.[92] Early adoption is

82. *Id.* at 3.
83. *Id.*
84. *Id.* at 3–4.
85. *Id.* at 3.
86. *Id.*
87. *Id.* at 4.
88. *Id.* at 5.
89. *Id.* at 4–5.
90. *Id.* at 5.
91. *Id.*
92. *Id.*

permitted as of fiscal years beginning after December 15, 2016, but public entities must early adopt also for interim periods within those fiscal years and other entities may defer adoption for interim periods until the interim period beginning one year after the annual period in which the entity first applies the guidance.[93] Entities must apply the amendments in ASU 2017-05 at the same time that they apply the amendments in ASU 2014-09 and must use the same transition method selected to implement ASU 2014-09, except that they may elect a different transition method for transactions with noncustomers than with customers.[94] ASU 2014-09 provides for implementation either retrospectively to each period presented in the financial statements (retrospective approach) or retrospectively with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption (modified retrospective approach).[95] An entity must apply the amended definition of a business in ASU 2017-01 to any contract with a noncustomer, regardless of the transition method it uses.[96]

6. Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost

In March 2017, the FASB issued ASU No. 2017-07,[97] which is intended to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost (referred to hereafter as "net benefit cost").[98] ASU 2017-07 addresses stakeholders' observations that the service cost component generally is analyzed differently from the other components of net benefit cost and is intended to improve the consistency, transparency, and usefulness of financial information to users.[99]

ASU 2017-06 is applicable to all employers, including not-for-profit entities, that provide to their employees defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under ASC Topic 715, Compensation—Retirement Benefits.[100] It specifies how the service cost and the other components of net benefit cost should be presented in the income statement and provides that only the service cost component of net benefit cost may be capitalized.[101] The service cost must be presented in the same line item or items as other compensation costs arising from services rendered by the employer during the period.[102] The other components of net benefit costs must be presented in the

93. *Id.*
94. *Id.* at 5–6.
95. *Id.* at 6.
96. *Id.*
97. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-07, Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost (Mar. 2017) [hereinafter ASU 2017-07].
98. *Id.* at 1.
99. *Id.* at 2.
100. *Id.* at 1.
101. *Id.* at 2.
102. *Id.*

income statement separately from the service cost component and after a subtotal of income from operations, if one is presented, and must be appropriately identified, when presented in a separate line item or items, or disclosed when they are not presented in a separate line item or items.[103]

ASU 2017-07 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017.[104] Other entities must adopt ASU 2017-07 for financial statements for fiscal years beginning after December 15, 2018, and for interim periods within fiscal years beginning after December 15, 2019.[105] Early adoption is permitted as of the beginning of an annual period for which neither annual nor interim financial statements have been issued or made available for issuance.[106] At the time of adoption, an entity must disclose the nature of and reason for the change in the accounting principle.[107] The presentation amendments must be applied retrospectively whereas the requirement that the service cost be capitalized must by applied prospectively on and after the effective date.[108] ASU 2017-07 provides a practical expedient that permits an entity to use the amounts disclosed in its pension and other postretirement benefit plan note for the prior comparative periods as the estimation basis for applying the retrospective presentation requirements provided the entity discloses such use.[109]

7. Amortization Period for Purchased Callable Debt Securities

In March 2017, the FASB issued ASU 2017-08[110] to shorten the amortization period for the premium on certain callable debt securities from a period ending upon the maturity date to a period ending upon the earliest call date.[111] This action addresses stakeholders' concerns that current GAAP excludes certain callable debt securities from consideration of a shorter amortization period even if the holder of the securities is certain that the call will be exercised.[112] Stakeholders also had told the FASB that there is diversity in practice in the treatment of the amortization period for premiums and the impairment assessment of the potential for exercise of a call and that the shortened amortization period would better align with the expectations incorporated in market pricing on the underlying securities.[113]

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103. *Id.*
104. *Id.* at 2–3.
105. *Id.* at 3.
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.*
110. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-08, Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities (Mar. 2017) [hereinafter ASU 2017-08].
111. *Id.* at 1–2.
112. *Id.* at 1.
113. *Id.*

ASU 2017-08 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018.[114] Other entities must adopt ASU 2017-08 for financial statements for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020.[115] Early adoption is permitted.[116] If an entity adopts ASU 2017-08 in an interim period, any adjustments must be reflected as of the beginning of the fiscal year that includes the interim period.[117] At the time of adoption, an entity must provide disclosures about a change in accounting principle.[118] Upon adoption, the amendments must be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption.[119]

8. Accounting for a Modification of a Share-Based Award

In May 2017, the FASB issued ASU 2017-09,[120] which provides guidance as to when a company must account for a change in the terms or conditions of a share-based payment award in accordance with the provisions in ASC Topic 718, Compensation—Stock Compensation ("ASC Topic 718"), related to the modification of awards.[121] This guidance is intended to provide clarity and reduce both diversity in practice and the cost and complexity of the accounting for changes to the terms and conditions of a share-based payment award.[122]

ASU 2017-09 provides that changes to the terms or conditions of a share-based payment award must be treated as a modification under ASC Topic 718 unless the following characteristics of the award are the same immediately before and after the change: (1) the fair value (or calculated value or intrinsic value, if the award is valued in that fashion); (2) the vesting conditions; and (3) the classification of the award as equity or liability.[123]

ASU 2017-09 is effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017.[124] Early adoption is permitted, including in any interim period, provided that the entity has not issued or made available for issuance the financial statements for the particular period.[125] The amendments must be applied prospectively to an award modified on or after the adoption date.[126]

114. *Id.* at 2.
115. *Id.*
116. *Id.*
117. *Id.*
118. *Id.*
119. *Id.*
120. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-09, Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting (May 2017) [hereinafter ASU 2017-09].
121. *Id.* at 1.
122. *Id.*
123. *Id.* at 2.
124. *Id.*
125. *Id.*
126. *Id.*

9. Financial Instruments with Down Round Features and Technical Amendments Relating to Financial Instrument Accounting Deferral Dates

In July 2017, the FASB issued ASU 2017-11,[127] which addresses two narrow issues involving financial instruments with characteristics of liabilities and equity.[128] Part I of ASU 2017-11 addresses the accounting for certain financial instruments with down round features, other than standard antidilution provisions,[129] and Part II revises ASC Topic 480, Distinguishing Liabilities from Equity, to address the concerns about the complexities of the guidance in that topic because of the existence of extensive pending content in the Codification.[130]

Part I of ASU 2017-11 is intended to address concerns about the significant reporting burden and unnecessary income statement volatility resulting from the current accounting for financial instruments, such as warrants and convertible instruments, with down round features that require a reduction in the strike price on the basis of the pricing of future equity offerings.[131] Current accounting requires freestanding and embedded instruments with down round features to be treated as liabilities subject to ongoing fair value measurement.[132] Thus, increases and decreases in the share price require the recognition in earnings of changes in the fair value of the financial instrument with the down round feature even though an increase in share price will not trigger a down round feature and a decrease will cause an adjustment to the strike price only if and when an entity engages in a subsequent equity offering.[133] ASU 2017-11 simplifies the accounting for financial instruments with down round features by providing that an equity-linked financial instrument (or embedded conversion option) no longer would be accounted for as a derivative liability at fair value as a result of the existence of a down round feature.[134] This will reduce costs because an entity will no longer need to measure the fair value of a separate instrument, such as a warrant, at each reporting period and will no longer need to separately account for a bifurcated derivative, in the case of convertible instruments, on the basis of the existence of a down round feature.[135] Entities with convertible instruments with embedded conversion options that have down round features will account for them under specialized guidance that requires the recognition of the intrinsic

127. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-11, Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480), Derivatives and Hedging (Topic 815): I. Accounting for Certain Financial Instruments with Down Round Features, and II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception (July 2017) [hereinafter ASU 2017-11].
128. *Id.* at 1.
129. *Id.* at 5 (clarification included in the definition of "Down Round Feature" to be added to the Master Glossary).
130. *Id.* at 1.
131. *Id.*
132. *Id.*
133. *Id.*
134. *Id.* at 2.
135. *Id.* at 3.

value of the down round feature only when the feature becomes beneficial and will not need to bifurcate the conversion option and measure it at fair value each reporting period.[136]

In addition, ASU 2017-11 provides that an entity that presents earnings per share in accordance with ASC Topic 260 must recognize the effect of the down round feature when it is triggered.[137] This means that the value of the down round feature is treated as a dividend and as a reduction of income available to common shareholders in basic earnings per share.[138]

Part II of ASU 2017-11 replaces the indefinite deferral of certain guidance in ASC Topic 480 with a scope exception, which the FASB believes improves the readability of ASC Topic 480 and reduces the complexity associated with implementing that guidance.[139]

The amendments in Part I of ASU 2017-11 are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018.[140] Other entities must adopt those amendments for financial statements for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020.[141] Early adoption is permitted.[142] If an entity adopts the Part I amendments of ASU 2017-11 in an interim period, any adjustments must be reflected as of the beginning of the fiscal year that includes the interim period.[143] Upon adoption, the amendments must be applied retrospectively to outstanding financial instruments with a down round feature either by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first fiscal year and interim period(s) in which the amendments are effective or by means of adjustments to each prior reporting period presented in accordance with the guidance on accounting changes in ASC 250-10-45-5 through 45-10.[144] The amendments in Part II are effective upon adoption because they have no accounting effect.[145]

10. Improvements in Hedge Accounting

In August 2017, the FASB issued ASU 2017-12,[146] which is intended to improve the financial reporting of hedging relationships to better reflect the economic results of an entity's risk management activities and to simplify the appli-

136. *Id.*
137. *Id.*
138. *Id.* at 2–3.
139. *Id.* at 3.
140. *Id.* at 4.
141. *Id.*
142. *Id.*
143. *Id.*
144. *Id.*
145. *Id.*
146. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities (Aug. 2017) [hereinafter ASU 2017-12].

cation of the hedge accounting guidance.[147] Not only had stakeholders noted the need for improvements in hedge accounting to facilitate financial reporting that more closely reflects an entity's risk management activities, but they had also noted that the current hedge accounting is often difficult to understand and interpret.[148]

To better align an entity's risk management activities and financial reporting for hedging relationships, the amendments change both the designation and measurement guidance for qualifying hedging relationships as well as the presentation of hedge results.[149] The designation guidance expands the eligibility for hedge accounting of certain cash flow and fair value hedging relationships involving both nonfinancial risk and interest rate risk hedges.[150] With respect to cash flow hedges of nonfinancial assets, the amendments remove the requirement in current GAAP that only the overall variability in cash flows or variability related to foreign currency risk could be designated as the hedged risk and provide that an entity can designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component stated in the contract.[151] With respect to cash flow hedges of interest rate risk of a variable-rate financial instrument indexed to a nonbenchmark interest rate, the amendments remove the requirement that only the overall variability in cash flows could be designated as the hedged risk and provide that an entity can designate as the hedged risk the variability in cash flows attributable to the contractually specified interest rate.[152] With respect to a fair value hedge of interest rate risk, the amendments add the Securities Industry and Financial Markets Association ("SIFMA") Municipal Swap Rate as an eligible benchmark interest rate in the United States in addition to those already permitted under current GAAP, thereby permitting an entity that issues or invests in fixed-rate tax exempt financial instruments to designate as the hedged risk changes in fair value attributable to interest rate risk related to the SIFMA Municipal Swap Rate rather than overall changes in fair value.[153]

The amendments also address limitations on the accounting for fair value hedges of interest rate risk that may not align with an entity's risk management strategies or the way in which interest rate risk can be hedged in the cash flow hedging model.[154] To address these issues, the amendments change the guidance for designating fair value hedges of interest rate risk and for measuring the change in the fair value of the hedged item in fair value hedges of interest rate risk.[155] These amendments permit an entity to:

147. *Id.* at 1.
148. *Id.*
149. *Id.*
150. *Id.* at 2.
151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.* at 2–3.
155. *Id.* at 3.

- measure the change in the fair value of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows determined at hedge inception, rather than on the full contractual coupon cash flows, as required by current GAAP;[156]
- measure the hedged item in a partial-term fair value hedge of interest rate risk by assuming the hedged item has a term that reflects only the designated cash flows being hedged, whereas current GAAP prohibits this methodology;[157]
- consider, with respect to a prepayable financial instrument, only how changes in the benchmark interest rate affect a decision to settle the debt instrument before its scheduled maturity in calculating the change in the fair value of the hedged item attributable to interest rate risk;[158] and
- designate, with respect to a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, an amount that is not expected to be affected by prepayments, defaults, and other events that affect the timing and amount of cash flows, thereby eliminating the consideration of prepayment risk in the measurement of the hedged item.[159]

To improve the understandability of the results of an entity's hedging strategy and simplify the financial reporting of qualifying hedge instruments, the amendments eliminate the need to separately measure and report hedge ineffectiveness and, instead, provide the following recognition and presentation guidance for qualifying hedge instruments:

- For fair value hedges, the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness must be presented in the same income statement line that is used to present the earnings effect of the hedged item.[160]
- For cash flow and net investment hedges, the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness is recorded in other comprehensive income (for cash flow hedges) or in the currency translation adjustment section of other comprehensive income (for net investment hedges) and, upon reclassification to earnings, is reflected in the same income statement line item that is used to present the earnings effect of the hedged item when the hedged item affects earnings.[161]

156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.* at 4.
161. *Id.*

The amendments expand the items that an entity may exclude from the assessment of hedge effectiveness to include also the portion of the change in fair value of a currency swap that is attributable to a cross-currency basis spread.[162] With respect to those items excluded from the assessment of hedge effectiveness, the amendments permit an entity to recognize in earnings the initial value of the excluded items using a systematic and rational method over the life of the hedging instrument.[163] If an entity elects this method, it must recognize the difference between the change in the fair value of the excluded component and the amounts recognized under the systematic and rational method in other comprehensive income unless the hedge is a net investment hedge.[164] The difference between the change in the fair value of the excluded component of a net investment hedge and the amounts recognized under the systematic and rational method must be recognized in the cumulative translation adjustment section of other comprehensive income.[165] Alternatively, an entity may continue to recognize all fair value changes in an excluded component in earnings, consistent with current GAAP.[166]

ASU 2017-12 includes various other targeted improvements that are intended to simplify the application of current GAAP related to hedge effectiveness testing.[167] These amendments permit an entity:

- that is required to initially perform a quantitative assessment of hedge effectiveness, to perform subsequent testing on a qualitative basis, provided it complies with certain verification and documentation requirements;[168]
- that is evaluating whether the maturity requirement in the critical terms match method is met for a group of forecasted transactions, to assume that the maturity requirement is met as long as both the derivative maturity and the forecasted transactions occur within the same thirty-one-day period or fiscal month;[169]
- to perform the initial prospective quantitative assessment of hedge effectiveness at any time between hedge designation and the first quarterly effectiveness testing date, provided it uses data applicable as of the date of hedge inception;[170]
- that is a private company, other than a financial institution and a not-for-profit company that does not meet the definition of public business entity, to take additional time to complete its documentation of hedge effectiveness;[171] and

162. *Id.*
163. *Id.* at 5.
164. *Id.*
165. *Id.*
166. *Id.*
167. *Id.*
168. *Id.*
169. *Id.*
170. *Id.* at 5–6.
171. *Id.* at 6.

- that determines that its prior use of the shortcut method was not or is no longer appropriate, to assess hedge effectiveness using the long-haul method as long as the hedge is highly effective and the entity documents at inception which long-haul methodology it will use.[172]

ASU 2017-12 also changes the disclosure required about hedging activities.[173] The amendments include the elimination of the requirement to disclose the ineffective portion of the change in the fair value of hedging instruments, but expands the disclosures to require tabular presentations related to the effect on the income statement of fair value and cash flow hedges and cumulative basis adjustments for fair value hedges.[174]

ASU 2017-12 is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018.[175] Other entities must adopt ASU 2017-12 for financial statements for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020.[176] Early adoption is permitted.[177] The effect of the adoption must be reflected as of the beginning of the fiscal year in which the statement is adopted.[178] All transition requirements and elections must be applied to all hedging relationships in existence as of the adoption date.[179] An entity must reflect a cumulative-effect adjustment related to eliminating the separate measurement of ineffectiveness of cash flow and net investment hedges to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption of the standard.[180] The amended presentation and disclosure requirements are required only on a prospective basis.[181]

11. SEC Revenue Recognition and Lease Accounting Effective Date Relief for Public Business Entities That Are Not Issuers and Changes Related to SEC Revenue Recognition and Lease Accounting Guidance

In September 2017, the FASB issued ASU 2017-13[182] to add SEC guidance related to the impact of the effective dates of the revenue recognition and

172. *Id.*
173. *Id.*
174. *Id.*
175. *Id.* at 7.
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.*
181. *Id.*
182. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-13, Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments (Sept. 2017) [hereinafter ASU 2017-13].

lease accounting standards on various entities that meet the FASB's definition of public business entities solely because another entity must include financial information for those entities in their SEC filings. In addition, ASU 2017-13 amends the Codification to reflect the rescission by the SEC Staff of certain guidance in ASC Topic 605, Revenue Recognition (the "Superseded ASC 605"), and ASC Topic 840, Leases (the "Superseded ASC 840"), that will not apply once entities adopt the new FASB guidance related to revenue recognition (ASC Topic 606) and lease accounting (ASC Topic 842, Leases ("ASC Topic 842") and to move certain SEC Staff guidance related to lease accounting from Superseded ASC 840 to ASC Topic 842.[183]

The SEC Staff announced at the meeting of the EITF on July 20, 2017, that it would not object if an entity that meets the FASB's definition of public business entity solely because its financial statements or financial information must be included in another entity's SEC filings complies with the effective dates for revenue recognition in ASC Topic 606 and lease accounting in ASC Topic 842 at the effective dates applicable to entities that do not meet the FASB's definition of public business entity.[184] The FASB codified the text of the SEC Staff's announcement in ASC 606-10-S65-1, with respect to the revenue recognition standard,[185] and ASC 842-10-S65-1, with respect to the lease accounting standard.[186]

The SEC Staff is rescinding its guidance set forth in ASC 605-20-S99-1 related to management fees based on a formula in ASU 2017-13.[187] In addition, ASU 2017-13 modifies ASC 605-20-S25-2 and ASC 605-S50-1, which reference the SEC Staff's rescinded guidance, to note that the paragraphs have been superseded.[188] These revisions are effective upon an entity's initial adoption of ASC Topic 606.[189]

With respect to lease accounting, ASU 2017-13 rescinds certain paragraphs and moves another paragraph in Superseded ASC 840 that articulate the SEC Staff's views on lease accounting in light of the FASB's new lease accounting guidance in ASC Topic 842.[190] The rescissions, which are effective upon an entity's initial adoption of ASC Topic 842,[191] relate to a lessor's consideration of third-party value guarantees (ASC Topic 840-30-S99-1), the sale treatment in sale-leaseback transactions with a repurchase option (ASC Topic 840-40-S99-1), the effect of a lessee's involvement in the construction of an asset (ASC Topic 840-40-S99-2), and the application of sales-leaseback guidance to certain sales-leaseback transactions (ASC Topic 840-40-S99-3).[192] In addition, ASU 2017-13 moves the paragraph that articulates the SEC Staff's views on the effect of a change in tax law

183. *Id.* at 1, 6, 10.
184. *Id.* at 3.
185. *Id.* at 2–4.
186. *Id.* at 4.
187. *Id.* at 6.
188. *Id.* at 7.
189. *Id.* at 6.
190. *Id.* at 10.
191. *Id.*
192. *Id.* at 10–14.

or rates on leveraged leases from superseded ASC 840-30-S99-1 to ASC Topic 842-50-S99-1.[193]

12. Changes to SEC Revenue Recognition Guidance

In November 2017, the FASB issued ASU 2017-14[194] to rescind certain paragraphs in Superseded ASC Topic 605 that set forth the SEC Staff's views on revenue recognition and amend and add various paragraphs to articulate the SEC's views as a result of the issuance by the SEC Staff of a new Staff Accounting Bulletin ("SAB") and the issuance by the SEC of a new release relating to revenue recognition.[195]

The SEC Staff issued SAB No. 116[196] on August 18, 2017, to modify portions of its interpretive guidance included in its Codification of Staff Accounting Bulletins to conform the guidance with ASC Topic 606.[197] This action included the modification of the guidance in SAB Topic 13: *Revenue Recognition*, of the Codification of Staff Accounting Bulletins ("SAB Topic 13") related to bill-and-hold arrangements[198] in light of the SEC's issuance of Securities Act Release No. 33-10402.[199] In SEC Release No. 44-10402, the SEC stated that, upon a registrant's adoption of ASC Topic 606, the registrant should no longer refer to the SEC's guidance in Securities Exchange Act Release No. 23507 and Accounting and Auditing Enforcement Release No. 108, In the Matter of Steward Parness ("AAER 108"), which sets forth criteria to be met in order for a registrant to recognize revenue when delivery has not occurred, a bill-and-hold arrangement.[200] The SEC Staff included the criteria identified in AAER 108 in SAB Topic 13, which sets forth the SEC Staff's guidance on the basic principles of revenue recognition.[201] The SEC noted that ASC Topic 606 provides specific guidance with respect to bill-and–hold arrangements.[202]

Specifically, SAB No. 116 provides that SAB Topic 13 and Topic 8: Retail Companies of the Codification of Staff Accounting Bulletins ("SAB Topic 8") are no longer applicable upon a registrant's adoption of ASC Topic 606 because ASC Topic 606 eliminates the need for the SEC Staff's revenue recognition guid-

193. *Id.* at 15–16.
194. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-14, Income Statement—Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605), and Revenue from Contracts with Customers (Topic 606): Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 116 and SEC Release No. 33-10403 (Nov. 2017) [hereinafter ASU 2017-14].
195. *Id.* at 1, 45.
196. Staff Accounting Bulletin No. 116 (Aug. 18, 2017) ("SAB 116"), https://www.sec.gov/interps/account/sab116.pdf [hereinafter SAB No. 116].
197. *Id.* at 1.
198. *Id.* at 3.
199. Commission Guidance Regarding Revenue Recognition for Bill-and-Hold Arrangements, Securities Act Release No. 33-10402 (Aug. 18, 2017), https://www.sec.gov/rules/interp/2017/33-10402.pdf [hereinafter SEC Release No. 33-10402].
200. *Id.* at 1.
201. *Id.* at 2.
202. *Id.* at 3.

ance.[203] In addition, SAB No. 116 amends Topic 11: Miscellaneous Disclosure of the Codification of Staff Accounting Bulletins ("SAB Topic 11") to clarify in SAB Topic 11.A that revenues from operating-differential subsidies presented under a revenue caption should be presented separately from revenue from contracts with customers accounted for under ASC Topic 606.[204] SAB No. 116 notes that registrants should continue to refer to prior SEC and SEC Staff guidance on revenue recognition topics until they adopt ASC Topic 606.[205]

In light of the fact that SAB Topic 13 will no longer be applicable to registrants upon their adoption of ASC Topic 606, ASU 2017-14 amends superseded ASC 605-10-S25-1 through 4 and ASC Topic 605-10-S50-1 to note that each of such paragraphs has been superseded by ASU 2017-14 and to remove the text of SAB Topic 13 from ASC Topic 605-10-S99-1.[206] In light of the fact that SAB Topic 8 will no longer be applicable to registrants upon their adoption of ASC Topic 606, ASU 2017-14 amends Superseded ASC 605-15-S25-1, Superseded ASC 605-15-S45-1, and Superseded ASC 605-15-S50-2 to note that each of such paragraphs has been superseded by ASU 2017-14 and removes the text of SAB Topic 8 from Superseded ASC 605-15-S99-2 through S99-3.[207] In addition, ASU 2017-14 amends a paragraph of ASC Topic 220, Income Statement—Reporting Comprehensive Income, ASC 220-10-S99-7, to set forth the SEC Staff's revision to SAB Topic 11.A, which was included in SAB 116, and to add a reference to ASC Topic 606.[208]

Finally, ASU 2017-14 adopts various amendments in light of the SEC's issuance in August 2017 of Securities Act Release No. 33-10403,[209] in which the SEC updated its guidance related to vaccine stockpiles.[210] SEC Release No. 33-10403 conforms the guidance that the SEC issued in 2005 (the "2005 SEC Guidance") relating to the accounting for sales of vaccines and bioterror countermeasures to the federal government for placement into stockpiles related to the Vaccines for Children Program and the Strategic National Stockpile to ASC Topic 606.[211] In light of SEC Release No. 33-10403, ASU 2017-14 amends Superseded ASC 605-15-S25-2 and Superseded ASC 605-15-S50-1 to note that each of such paragraphs is superseded by ASU 2017-14, removes the text of the 2005 SEC Guidance from Superseded ASC 605-15-S99-1, and amends ASC 606 to include the text of SEC Release No. 33-10403 in new ASC 606-10-S25-1.[212]

203. SAB No. 116, *supra* note 196, at 3–4.
204. *Id.* at 4.
205. *Id.* at 1–2.
206. ASU 2017-14, *supra* note 194, at 2–42.
207. *Id.* at 42–45.
208. *Id.* at 1–2.
209. Updates to Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile, Securities Act Release No. 33-10403 (Aug. 18, 2017), https://www.sec.gov/rules/interp/2017/33-10403.pdf [hereinafter SEC Release No. 33-10403].
210. *Id.* at 1.
211. *Id.*
212. ASU 2017-14, *supra* note 194, at 45–56.

13. Elimination of Obsolete Guidance for Unrecognized Deferred Limitation of Unrecognized Deferred Taxes Related to Statutory Reserve Deposits Made Prior to December 16, 1992

In December 2017, the FASB issued ASU 2017-15[213] to eliminate ASC Topic 995, U.S. Steamship Entities, because its guidance had become obsolete.[214] This project was undertaken as a part of the FASB's ongoing project on its agenda to clarify the Codification or correct unintended results of application of the guidance.[215]

ASC Topic 995 provides guidance on the accounting for unrecognized deferred tax liabilities of U.S. steamship entities resulting from temporary differences between the tax and accounting treatment of deposits in statutory reserve funds that arose in fiscal years beginning on or before December 15, 1992.[216] The statutory reserve deposits resulted from a Department of Transportation program and Internal Revenue Service guidance that provided that the tax deferral would be forfeited if not used within a twenty-five-year time frame.[217] The FASB concluded that ASC Topic 995 is no longer relevant because all of the statutory funds deposited on or before December 15, 1992, have reached the twenty-five-year limit.[218]

ASU 2017-15 is effective for fiscal years and first interim periods beginning after December 15, 2018.[219] Early adoption is permitted, including adoption in an interim period.[220] Upon adoption, the amendments must be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption.[221] In addition, an entity must provide the disclosures about a change in accounting principle and disclose the amounts and types of temporary differences for which a deferred tax liability had not previously been recognized.[222]

B. ASUs Originated by the EITF

1. Employee Benefit Plan and Master Trust Reporting

In February 2017, in response to an EITF consensus, the FASB issued ASU No. 2017-06,[223] which is intended to improve the usefulness of the information in the

213. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-15, Codification Improvements to Topic 995, U.S. Steamship Entities: Elimination of Topic 995 (Dec. 2017) [hereinafter ASU 2017-15].
214. *Id.* at 1.
215. *Id.*
216. *ASC Topic 995-740-15-1 and 15-2*, Fin. Acct. Standards Board, https://asc.fasb.org/industryviewall&trid=2157037 (last visited Feb. 21, 2018) (password protected).
217. ASU 2017-15, *supra* note 213, at 1.
218. *Id.*
219. *Id.* at 2.
220. *Id.*
221. *Id.*
222. *Id.*
223. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-06, Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962),

financial statements of a defined benefit pension plan, a defined contribution pension plan, and a health and welfare benefit plan (referred to jointly as the "Plan") about the Plan's interest in a master trust.[224] A master trust is a trust that holds assets of more than one employee benefit plan sponsored by a single employer or by a group of employers under common control and that has as its trustee a regulated financial institution, such as a bank, trust company, or similar financial institution that is regulated, supervised, and subject to periodic examination by a state or federal agency.[225] The FASB issued the ASU in response to stakeholder comments that current GAAP disclosure requirements related to the interests of employee benefit plans in master trusts were limited and incomplete.[226]

ASU 2017-06 revises ASC Topic 962 related to defined contribution pension plans and ASC Topic 965 related to health and welfare benefit plans to require the presentation of investments in master trusts in a single line item in the statement of net assets available for benefits, as required by the current requirement of ASC Topic 960 related to defined benefit pension plans.[227] In addition, ASU 2017-06 amends all three ASC topics to require the presentation of any change in the Plan's interest in a master trust in a separate line item in the statement of changes in net assets available for benefits.[228]

ASU 2017-06 also amends ASC Topics 960 and 962 to remove the requirement that each Plan subject to those topics disclose its percentage interest in the master trust when the Plan has a specific rather than a proportionate interest in the individual investments of the master trust.[229] ASU 2017-06 requires each Plan covered by ASC Topics 960, 962, and 965 to disclose the dollar amount of its interest in each of the general types of investments of the master trust, which will supplement the existing disclosures of the master trust's balances in such investments.[230] In addition, ASU 2017-06 will require the Plans to disclose the following: (1) the master trust's other asset and liability balance and (2) the dollar amount of the Plans' interests in each of those balances.[231] Finally, ASU 2017-06 eliminates a redundancy in the financial statements of defined benefit pension plans and health and welfare benefit plans by removing the investment disclosure requirements related to 401(h) account[232] assets from the requirements applicable to health and welfare benefit plan financial statements

Health and Welfare Benefit Plans (Topic 965): Employee Benefit Plan Master Trust Reporting (Feb. 2017) [hereinafter ASU 2017-06].

224. *Id.* at 1.
225. *Id.*
226. *Id.*
227. *Id.* at 2.
228. *Id.*
229. *Id.*
230. *Id.*
231. *Id.*
232. A "401(h) account" is defined in the Codification as "[a] postretirement medical-benefit component provided in some defined benefit pension plans in addition to the normal retirement benefits of the plan, pursuant to Section 401(h) of the Internal Revenue Code." *Master Glossary, Accounting Standards Codification*, FIN. ACCT. STANDARDS BOARD, https://asc.fasb.org/glossary&letter=P (last visited Feb. 21, 2018) (password protected).

and requiring instead disclosure of the name of the defined benefit pension plan in which those investment disclosures are provided.[233]

ASU 2017-06 is effective for fiscal years beginning after December 15, 2018.[234] Early adoption is permitted.[235] Upon adoption, the amendments must be applied on a retrospective basis to each period for which financial statements are provided.[236]

2. Determining the Customer in a Service Concession Arrangement

In May 2017, in response to an EITF consensus, the FASB issued ASU No. 2017-10,[237] which addresses diversity in practice observed by stakeholders in how an operating entity under a service concession arrangement within the scope of ASC Topic 853, Service Concession Arrangements ("ASC Topic 853"), determines its customer.[238] A service concession arrangement is an arrangement under which an operating entity agrees with a public-sector grantor to operate, for a specified period of time, the grantor's infrastructure (such as airports, roads, bridges, tunnels, prisons, and hospitals).[239] Service concession arrangements under ASC Topic 853 are those in which the grantor both: (1) controls, or has the ability to modify or approve, the services that the operating entity must provide, the recipient of those services, and the price of the services; and (2) controls any residual interest in the infrastructure at the end of the term of the arrangement as a result of ownership, beneficial entitlement or otherwise.[240]

ASU 2017-10 provides that the customer is the grantor in all service concession arrangements within the scope of ASC Topic 853.[241] This will enable more consistent application of certain aspects of the revenue guidance, both under Superseded ASC Topic 605 and ASC Topic 606.[242]

ASU 2017-10 is effective at the same time as ASC Topic 606 for entities that had not adopted ASC Topic 606 before the issuance of ASU 2017-10.[243] Upon adoption of ASC Topic 606, an entity must also adopt the amendments in ASU 2017-10 and use the same transition method elected for the application of ASC Topic 606.[244] An entity may early adopt the amendments in ASU 2017-10 before adopting ASC Topic 606 but may not use any of the practical expedients

233. ASU 2017-06, *supra* note 223, at 2.
234. *Id.* at 3.
235. *Id.*
236. *Id.*
237. Fin. Accounting Standards Bd., Accounting Standards Update No. 2017-10, Service Concession Arrangements (Topic 853): Determining the Customer of the Operation Services (May 2017) [hereinafter ASU 2017-10].
238. *Id.* at 1.
239. *Id.*
240. *Id.*
241. *Id.* at 2.
242. *Id.*
243. *Id.* See the discussion about the effective date of ASC Topic 606 at the text accompanying *supra* notes 85–87.
244. ASU 2017-10, *supra* note 237, at 3.

in ASC 606-10-65-1(f) and must use either the modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the fiscal year of adoption or the retrospective approach.[245] The transition disclosures depend on the transition method that the entity elects for application of the amendments.[246]

The effective date of ASU 2017-10 for public business entities and certain other entities and employee benefit plans that had already adopted ASC Topic 606 as of the issuance of ASU 2017-10 is for financial statements for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.[247] For all other entities that had already adopted ASC Topic 606 as of the issuance of ASU 2017-10, the effective date of ASU 2017-10 is for financial statements for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.[248] The transition method for application of the amendments in ASU 2017-10 need not be the same as the method used for application of ASC Topic 606 but the same practical expedients must be used, to the extent applicable.[249] Either a modified retrospective approach with a cumulative-effect adjustment to equity recorded as of the beginning of the fiscal year of adoption or a retrospective approach must be used.[250] The transition disclosures depend on the transition method that the entity elects for application of the amendments.[251] An entity may adopt the amendments in ASU 2017-10 early, including in an interim period as long as it reflects any adjustments as of the beginning of the fiscal year that includes that interim period.[252]

245. *Id.*
246. *Id.*
247. *Id.*
248. *Id.*
249. *Id.*
250. *Id.*
251. *Id.*
252. *Id.* at 4.

Caselaw Developments 2017*

Overview

Supreme Court. The Supreme Court held that the five-year statute of limitations in section 2462 of U.S. Code Title 28 applies to Securities and Exchange Commission ("SEC" or "Commission") claims for disgorgement.[1] The Court held also that the filing of a purported class action does not toll the three-year repose period in section 13 of the Securities Act of 1933 ("Securities Act") for all asserted class members.[2]

SEC Rulemaking. The D.C. Court of Appeals found that the SEC order approving a revised capital plan for the Options Clearing Corporation ("OCC") was arbitrary and capricious and unsupported by substantial evidence because the SEC had relied so heavily on the findings and conclusions of the OCC Board that the agency had effectively abdicated its obligation to review the plan for compliance with statutory standards.[3]

Disclosure of Interim Financial Figures During an Offering. Rejecting the First Circuit's "extreme departure" test for determining whether an issuer in registration must disclose financial numbers more current than those in its registration statement, the Second Circuit reaffirmed and applied its test, which asks whether the interim financial results constitute a material fact that, if not disclosed, would render the numbers in the registration statement misleading.[4]

Reg D Rule 508. In an unexpected blockbuster, the Eleventh Circuit held that a defendant *in an SEC enforcement action* alleging the sale of securities without either registration or an exemption can use Regulation D Rule 508 to argue that the offering satisfied Regulation D, except for failures that constituted "insignificant deviations" that under Rule 508 do not result in loss of the exemption.[5]

Insider Trading. The First Circuit held that gifts from a tippee to the tipper's son established whatever relationship was needed to infer that the tipper anticipated a benefit from conveying material nonpublic information to the tippee.[6] The Second Circuit provided a more provocative decision, holding that no particular relation-

* The caselaw developments section covers opinions decided during the calendar year 2017. Where this portion of the annual review expresses opinions, they are those of the author of the caselaw developments, William O. Fisher, and not necessarily the opinions of other authors contributing to the annual review, or of members of the subcommittee producing the review, or of the American Bar Association.

1. *See infra* notes 28–38 and accompanying text.
2. *See infra* notes 39–55 and accompanying text.
3. *See infra* notes 56–95 and accompanying text.
4. *See infra* notes 96–129 and accompanying text.
5. *See infra* notes 130–48 and accompanying text.
6. *See infra* notes 169–96 and accompanying text, particularly at notes 182–86.

ship need be established at all to show that the tipper expected a benefit from conveying the information and that any necessary benefit could be inferred from an expectation by the tipper that the tippee would trade on the information.[7]

Manipulation. The Second Circuit held that institutional investors stated a cause of action against national securities exchanges for arrangements facilitating high frequency trading where the arrangements allegedly led to higher prices that were not set by supply and demand and the exchanges' alleged role in the manipulation consisted of representing the prices to the investors as set in a fair and competitive way.[8]

Scienter and Scienter Pleading. The Fourth Circuit held that a complaint alleging facts from which it might be inferred that an executive knew what he was saying was false did not necessarily supply the "strong inference" of scienter that the Securities Exchange Act of 1934 ("Exchange Act") requires for a private Rule 10b-5 action seeking damages.[9] The Ninth Circuit found a complaint failed to adequately plead scienter (or even falsity) where it failed to connect the timing of the events described in a government report, and the knowledge of that report, to the timing of the defendants' statements.[10] The Fifth Circuit determined that plaintiffs had not sufficiently pled scienter, in part because a defendant's knowledge that his statement was wrong depended on his having studied data in an attachment to an email sent to him.[11]

Materiality. The First Circuit affirmed a lawyer's conviction for securities fraud based on false statements in Rule 144 letters, holding that those misrepresentations could be material even if the subject securities were freely tradable by a novel interpretation of another part of the securities law.[12] The Second Circuit affirmed dismissal of a claim by a retiree that his employer had not disclosed pending merger negotiations when he voluntarily left the company and thereby forfeited profit interests, on the ground that he knew that the employer's business plan was to sell itself and therefore the undisclosed negotiations to do so were not material.[13]

Falsity of Opinions. The Ninth Circuit held that the Supreme Court's taxonomy of the different ways in which an opinion might be false—set out in a case brought under section 11, which does not require scienter—applies in Rule 10b-5 cases, where scienter is an element.[14]

Forward-looking Statements. The Ninth Circuit held that, where a forward-looking statement was joined with a statement of current fact and the plaintiffs pled that the defendants had actual knowledge that the current fact was false, no cautionary language could invoke the statutory protection for the forward-looking statement, as no caution would be sufficient unless it admitted that the joined rep-

7. *See infra* notes 198–214 and accompanying text.
8. *See infra* notes 216–45 and accompanying text.
9. *See infra* notes 254–76 and accompanying text.
10. *See infra* notes 279–87 and accompanying text.
11. *See infra* notes 288–313 and accompanying text.
12. *See infra* notes 318–28 and accompanying text.
13. *See infra* notes 329–33 and accompanying text.
14. *See infra* notes 334–67 and accompanying text.

resentation of current fact was false.[15] The Third Circuit held that a risk warning that sales might suffer if the issuer lost distributors was not misleading even if the risk of losing an important distributor had matured at the time of the warning due to the company's decision to replace that distributor with its own sales force; the warning was not that distributors might leave but of the consequences of such departures, and the complaint did not allege that any such consequences had matured by the time the company included the warning in its Form 10-K.[16]

Proper Defendant in a Rule 10b-5 Case Based on Misrepresentations. The D.C. Circuit held that a director of investment banking at a broker-dealer could be liable under Rule 10b-5(a) and (c) for cutting and pasting into his own email falsehoods that his boss directed he send to investors even though the emails said that the director was sending them at the direction of his boss and even though the court conceded that, under the rule in the Supreme Court's *Janus* decision, the director could not be liable under Rule 10b-5(b).[17]

Showing an Efficient Market for Rule 23(b) Class Certification. The Second Circuit held that a plaintiff seeking certification of a Rule 23(b) class can prove market efficiency without statistical evidence that the price of the relevant security moved in a rationally directional manner in response to disclosure of information, provided that other factors identified in the *Cammer v. Bloom* and *Krogman v. Sterritt* decisions supply indirect support for efficiency.[18] That same court held, in a second case, that (i) when all of the indirect proof points to market efficiency, a court can find efficiency based solely on such indirect proof without reaching any conclusion based on an event study that the price of the relevant security moves in response to information, and (ii) when the defense challenges market efficiency on a certification motion, the defense cannot prevail simply by coming forward with *some* evidence that the particular alleged misrepresentation did not impact the price, but only through showing the absence of price impact by a preponderance of the evidence.[19]

Loss Causation in Rule 10b-5 Cases. In a case where an issuer represented that the business reviews it published were authentic, whereas plaintiffs alleged that the issuer manipulated the reviews to favor those businesses that advertised through the issuer and to punish those that did not, the Ninth Circuit found that the complaint did not sufficiently allege loss causation by pleading that reports of customer complaints to the Federal Trade Commission constituted a corrective disclosure.[20] In a case where plaintiffs alleged that a hospital company represented that its earnings derived from efficiencies, whereas plaintiffs alleged that the earnings derived significantly from improperly admitting patients to hospitals instead of treating them with outpatient services, the Sixth Circuit found that a civil complaint filed against the issuer in a takeover contest could constitute a corrective disclosure,

15. *See infra* notes 374–92 and accompanying text.
16. *See infra* notes 393–418 and accompanying text, particularly at notes 408–12.
17. *See infra* notes 420–56 and accompanying text.
18. *See infra* notes 468–76 and accompanying text.
19. *See infra* notes 477–510 and accompanying text.
20. *See infra* notes 517–22 and accompanying text.

but only because of special facts, including that the complaint summarized two expert reports concluding that the issuer systematically admitted patients when it was clinically improper to do so.[21]

Life Sciences Companies' Interactions with the Food and Drug Administration ("FDA"). The Third Circuit found a complaint failed to allege that statements were false or misleading where the plaintiffs claimed that the company did not reveal the FDA's resistance to approving a drug based on testing for a surrogate endpoint but the court interpreted the chronology to show that the agency did not reject the endpoint during the asserted class period.[22] The First Circuit ruled that a complaint failed to sufficiently allege scienter where the company represented that the FDA was open to reviewing data on a surrogate endpoint but also disclosed that the agency had not committed to use of that endpoint as a predictor of clinical benefit.[23]

Section 12(a)(2) Elements and Defenses. The Second Circuit affirmed a judgment against two banks for violations of section 12(a)(2) of the Securities Act, and state securities law, in the sale of residential mortgage-backed securities to the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association.[24] The decision ranged widely through the elements of such a claim and included such holdings as that (i) any statutorily driven preference that these purchasers had for mortgages issued to moderate- and low-income borrowers was irrelevant to the materiality of misrepresentations that the mortgages were made in conformity to underwriting guidelines of the originators and (ii) the defense that the credit crisis, rather than the misrepresentations, caused any loss failed because the defendants did not disaggregate the crisis from the misrepresentations, which were instead intertwined with that financial event.[25]

Supreme Court

In 2017, the Supreme Court held that disgorgement is a "penalty" within the meaning of the federal statute imposing a five-year limitations period on government actions for penalties.[26] The Court also held that the tolling rule set out in *American Pipe & Construction Co. v. Utah* does not extend the three-year period of repose in section 13 of the Securities Act.[27]

Statute of Limitations Applied to SEC Disgorgement Actions. The SEC can seek disgorgement as one of several possible remedies in enforcement actions.[28] Section 2462 of U.S. Code Title 28 applies a five-year statute of limitations to any

21. *See infra* notes 523–35 and accompanying text.
22. *See infra* notes 539–68 and accompanying text.
23. *See infra* notes 569–92 and accompanying text.
24. *See infra* notes 593–660 and accompanying text.
25. *See infra* notes 622–24 (materiality and the statutory requirement for investing in mortgages to moderate- and low-income borrowers) and notes 641–44 (loss causation defense) and accompanying text.
26. *See infra* notes 28–38 and accompanying text.
27. *See infra* notes 39–55 and accompanying text.
28. J. William Hicks, Civil Liabilities: Enforcement and Litigation Under the 1933 Act §§ 2:43–:44 (2017); 15 U.S.C. § 78u(d)(5) (2012) (Exchange Act) (authority for general equitable relief); *see also*

"action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise."[29] In 2017, the Supreme Court reversed the Tenth Circuit and held that the section 2462 five-year limitations period applies to SEC claims for disgorgement because disgorgement is a "penalty."[30]

The Court reasoned that categorization of government-sought relief as a "penalty" depends on two principles: (i) "'whether the wrong sought to be redressed is a wrong to the public, or a wrong to the individual'" and (ii) whether the relief "is sought 'for the purpose of punishment, and to deter others from offending in like manner'—as opposed to compensating a victim for his loss."[31] As to the first principle, the Commission conceded that "'[w]hen the SEC seeks disgorgement, it acts in the public interest, to remedy harm to the public at large, rather than standing in the shoes of particular injured parties.'"[32] And "'[t]he primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains.'"[33] As to the second principle, while "district courts may distribute the funds to victims" and "[s]ome disgorged funds are paid to victims," there is no "statutory command" that disgorged money be so distributed and "other funds are dispersed to the United States Treasury."[34] Moreover, the purpose of disgorgement is not to "simply return[] the defendant to the place he would have occupied had he not broken the law" because, for example, "[i]ndividuals who illegally provide confidential trading information have been forced to disgorge profits gained by individuals who received and traded based on that information—even though [the tippers] never received any profits."[35] Thus, since "disgorgement orders 'go beyond compensation, are intended to punish, and label defendants wrongdoers' as a consequence of violating public laws, they represent a penalty and . . . fall within the 5–year statute of limitations of § 2462."[36]

Significance and analysis. This holding merits two comments. First, the practical effect—in a case of a long-running securities law violation—can be to reduce the disgorgement down to the gains from wrongdoing received during the five years before the SEC files suit. Second, that limitation can effectively have a multiplier effect because courts have discretion to order interest on disgorgement.[37] Cutting off the older gains cuts off interest on them, which can be quite significant.[38]

SEC v. Cavanagh, 445 F.3d 105, 120 (2d Cir. 2006) (district courts have equitable power under the Judiciary Act to order disgorgement).

29. 28 U.S.C. § 2462 (2012).

30. Kokesh v. SEC, 137 S. Ct. 1635, 1641, 1645 (2017).

31. *Id.* at 1642 (quoting Huntington v. Attrill, 146 U.S. 657, 668 (1892)).

32. *Id.* at 1643 (quoting SEC brief). The Court also noted that the Commission can bring its enforcement action "even if victims do not support" it. *Id.*

33. *Id.* (quoting SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997)).

34. *Id.* at 1644.

35. *Id.*

36. *Id.* at 1645 (quoting Gabelli v. SEC, 568 U.S. 442, 451–52 (2013)).

37. *See, e.g.*, SEC v. Contorinis, 743 F.3d 296, 307–08 (2d Cir. 2014).

38. *See*, for an extreme case, SEC v. Warde, 151 F.3d 42, 46 (2d Cir. 1998) (affirming order that defendant disgorge about $872,000 and pay prejudgment interest of $1,260,000).

American Pipe *Tolling of Three-Year Period in Section 13 of the Securities Act.* Section 13 of the Securities Act provides that "[n]o action shall be maintained to enforce any liability created under section [11] . . . unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . *[and i]n no event shall any such action be brought to enforce [such] a liability . . . more than three years* after the security was bona fide offered to the public."[39] *American Pipe & Construction Co. v. Utah* held that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class."[40]

In *California Public Employees' Retirement System v. ANZ Securities, Inc.*, the Court addressed whether *American Pipe* tolling applies to the three-year period in section 13.[41] The plaintiff was a member of a class seeking recovery for alleged section 11 violations by Lehman Brothers Holdings Inc. based on asserted misrepresentations and omissions in registration statements effective in 2007 and 2008.[42] While that class action was pending, the plaintiff filed a separate complaint in February 2011—more than three years after the allegedly violative offerings.[43] The plaintiff then opted out of the class action when it settled, "apparently convinced [that] it could obtain a more favorable recovery in its separate suit."[44] The district court dismissed the separate case on the ground that the three-year bar forbade it, and the Second Circuit affirmed.[45]

Affirming that court of appeals decision,[46] the Court ruled that the three-year period in section 13 is a statute of repose because it "runs from the defendant's last culpable act (the offering of the securities), not from the accrual of the claim (the plaintiff's discovery of the defect in the registration statement)"[47] and because the "evident design of the . . . period was to protect defendants' financial security in fast-changing markets by reducing the open period for potential liability."[48] As a statute of repose, the three-year period "is in general not subject to tolling."[49] Tolling can extend such a period "only where there is a particular indication that the legislature did not intend the statute to provide complete repose but instead anticipated the extension . . . under certain circumstances."[50] Since "the source of the tolling rule applied in *American Pipe* is the judicial power to promote equity, rather than to interpret and enforce statutory provisions,"[51]

39. 15 U.S.C. § 77m (2012) (emphasis added).
40. 414 U.S. 538, 554 (1974).
41. 137 S. Ct. 2042, 2048 (2017).
42. *Id.* at 2048.
43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.* at 2055.
47. *Id.* at 2049. The Court found this "close to a dispositive indication that the [three-year period] is one of repose." *Id.*
48. *Id.* at 2050.
49. *Id.*
50. *Id.*
51. *Id.* at 2051.

and since "[t]he language of the 3-year statute does not refer to or impliedly authorize any exceptions for tolling"—"the text, purpose, structure, and history of the statute all disclos[ing] the congressional purpose to offer defendants full and final security after three years"[52]—"the *American Pipe* tolling rule does not apply to the 3-year bar mandated in § 13."[53]

Significance and analysis. Opt-outs from securities class actions are infrequent.[54] The most common opt-out plaintiffs are institutional investors.[55] These large investors can protect themselves. The effect of the Supreme Court's ruling may be simply to prompt such investors to make a protective, separate filing earlier in the class action. But that should impose little expense on those class members or the court system.

Courts of Appeals

SEC Rulemaking. The Options Clearing Corporation ("OCC") is a self-regulatory organization ("SRO") whose rules must be approved by the SEC before they go into effect.[56] The SEC "shall approve" proposed OCC rules if the SEC "*finds* that such proposed rule change is consistent with the requirements

52. *Id.* at 2051, 2052.

53. *Id.* at 2052. The majority distinguished *American Pipe* because the decision there applied the tolling to a statute of limitations rather than to a statute of repose. *Id.* at 2051–53. While the plaintiff argued that the class action from which it opted out had placed the defendants on notice of both the claims the plaintiff asserted and "the set of potential plaintiffs who might assert those claims," the majority observed that "the purpose of a statute of repose" is not just to put a defendant on notice of claims but to provide "full protection after a certain time." *Id.* at 2053. To the plaintiff's argument that the Court's ruling would "eviscerate [the] ability to opt out," the majority responded that the right to opt out did not carry with it the privilege to sidestep "mandatory time limits set by statute." *Id.* Although the plaintiff contended that "declining to apply *American Pipe* tolling to statutes of repose will create inefficiencies," the majority answered that (i) the rule it adopted had been in place in the Second Circuit since 2013 and plaintiff had "not offered evidence of any recent influx of protective filings" there and (ii) the protective maneuver could consist of "[a] simple motion to intervene or request to be included as a named plaintiff in the class-action complaint." *Id.* at 2053–54.

The majority rejected the plaintiff's additional argument that "the class-action complaint 'brought' [the plaintiff's] individual 'action' within the statutory time period." *Id.* at 2054. The majority found that "it defies ordinary understanding to suggest that [the plaintiff's complaint] . . .—in a separate forum, on a separate date, by a separate named party—was the same 'action,' 'proceeding,' or 'suit'" as the class action. *Id.*

The *California Public Employees' Retirement System* decision was five to four. *Id.* at 2046, 2056 (Ginsberg, J., dissenting). The dissenters argued that the class action served the purposes of the statute of repose by giving the defendants "notice of their potential liability" within the three-year window. *Id.* at 2056 (Ginsberg, J. dissenting).

54. Amir Rozen et al., Opt-Out Cases in Securities Class Action Settlements, 2012–2014 Update 2 (2016) ("We have identified 48 cases from 1996 to 2014 in which at least one party from the class opted out and filed a separate suit against the defendant, representing 3 percent of our sample of 1,458 cases. . . . We found no discernable increase in the preponderance of opt-outs over time.").

55. *Id.* (finding that, of 43 cases in which the researchers had information on the identity of opt-outs, "[t]he most common plaintiffs in opt-out cases [were] pension funds" (in 21 of the 43 cases) with "[o]ther institutional investors, including mutual funds, hedge funds, and other investment companies . . . involved in 20 opt-out cases" and 18 cases involving individual investors who opted out).

56. 15 U.S.C. § 78s(b)(1) (2012) (governing, among others, every "registered clearing agency," *id.* § (a)(1)); *What Is OCC?*, Options Clearing Corp., https://www.theocc.com/about/corporate-information/what-is-occ.jsp (last visited Dec. 30, 2017) (stating that the OCC is "a registered clearing agency" that is "under SEC jurisdiction").

of" the Exchange Act.[57] The Exchange Act (i) prohibits clearing agency rules from "impos[ing] any burden on competition not necessary or appropriate in furtherance of the purposes of [the act]";[58] (ii) requires the design of such rules "in general, to protect investors and the public interest";[59] (iii) prohibits the design of such rules "to permit unfair discrimination . . . among participants";[60] and (iv) requires each SRO to comply with its own procedures as it considers and adopts rules.[61]

In 2016, the SEC approved a rule change in OCC's capital plan (the "Amended Capital Plan").[62] At the time, twelve national securities exchanges cleared their options trades through OCC, with five of those exchanges holding shares in OCC and seven not.[63] OCC also had "clearing members."[64] At the time, OCC funded itself through fees that it charged to clearing members—with those fees paid annually and computed to include anticipated expenses for the upcoming year, plus a cushion.[65] At the end of the year, OCC refunded to the clearing members the excess of the fees paid over the actual costs incurred.[66]

The Amended Capital Plan—developed because the OCC "determined that it did not have enough capital to cover 'business, operational, and pension risks'"[67]—made the following changes pertinent here: First, the five exchanges holding OCC stock (the "Five Contributing Shareholders") would immediately provide $222 million in capital, and would promise to provide, on call, up to $117 million in additional capital (the "Replenishment Capital").[68] Second, the cushion over projected expenses used to compute annual fees would fall from 31 percent to 25 percent.[69] Third, the excess of fees over actual expenses paid would no longer be refunded in toto to the clearing members who paid the fees but would be split—with about half going to the Five Contributing Shareholders and about half going to the clearing members.[70] Finally, if the Replenishment Capital was called and not repaid within twenty-four months, or if the target total OCC capital requirement was not reached within that time, no refunds would be paid to the clearing members but dividends to the Five Contributing Shareholders would continue.[71]

57. 15 U.S.C. § 78s(b)(2)(C) (2012) (emphasis added).
58. *Id.* § 78q-1(b)(3)(I).
59. *Id.* § 78q-1(b)(3)(F).
60. *Id.*
61. *Id.* § 78s(g)(1).
62. Order Approving Proposed Rule Change Concerning the Options Clearing Corporation's Capital Plan, 81 Fed. Reg. 8294, 8294 (Feb. 18, 2016) [hereinafter Order Approving OCC Cap. Plan].
63. Susquehanna Int'l Grp., LLP v. SEC, 866 F.3d 442, 443 (D.C. Cir. 2017).
64. *Id.*
65. *Id.* at 444.
66. *Id.*
67. *Id.* (quoting Order Approving OCC Cap. Plan, *supra* note 62, at 8296).
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.*

Two exchanges that were not OCC shareholders, a clearing member, and a market participant petitioned the D.C. Circuit for review of the SEC order approving this plan.[72] The court remanded the order to the Commission, reasoning that the SEC's order suffered from a fundamental failure, which then overflowed into a number of specific flaws.[73] Fundamentally, the court found that "the SEC [had] effectively abdicated [the SEC's] responsibility to OCC," and that its order "reflect[ed] little or no evidence of the basis for the OCC's own determinations—and few indications that the SEC even knew what that evidence was."[74]

As to the "central issue" of whether the "dividend rate [to the Five Contributing Shareholders] represents an unnecessary windfall to [them],"[75] the SEC found that the rate "represents a reasonable return on the shareholders' capital contribution[s]"[76] but did so only on the basis that the OCC Board, "'with the assistance of independent outside financial experts, has determined [the rate] to be reasonable for the cost and risks associated'" with the Five Contributing Shareholders' obligations under the amended plan.[77] This failed the Exchange Act requirement that the SEC, itself, make the required "findings" and "determinations."[78] Moreover, such "unquestioning reliance . . . [was] not enough to justify approving" the Amended Capital Plan, and rendered the Commission's order "arbitrary and capricious" and "unsupported by substantial evidence," with the SEC approval therefore violating the Administrative Procedure Act ("APA").[79] To meet the APA standard, "the SEC should have critically reviewed the OCC's analysis or performed its own."[80] While the Commission responded that it was entitled to trust the process by which the OCC created its plan, the court rejected this argument because the "process" included the outside consultant who the OCC retained but whom the SEC "[did] not appear to have identified" and whose analysis the Commission did not appear to have even seen.[81] The "process" also featured negotiations between stakeholders that were supposedly "arm's-length," but which occurred with the Five Contributing Shareholders on both sides of the transaction (as OCC board members and recipients of the dividend) and with "[o]nly a small fraction of clearing members . . . on the Board and none of the nonshareholder exchanges."[82] More important than

72. *Id.*

73. *Id.* at 443, 446, 449, 451.

74. *Id.* at 446.

75. *Id.* If that were true, it would follow that the Amended Capital Plan "may run afoul of the Exchange Act's prohibitions by unnecessarily or inappropriately burdening competition, harming the interests of investors and the public, or unfairly discriminating against nonshareholders and clearing members." *Id.*

76. *Id.* (citing and quoting Order Approving OCC Cap. Plan, *supra* note 62, at 8301).

77. *Id.* at 446–47 (quoting Order Approving OCC Cap. Plan, *supra* note 62, at 8300). Similarly, on appeal, the SEC "candidly admit[ted] that it simply 'rel[ied] on the Board's analysis' of 'the rate of return.'" *Id.* at 447 (quoting SEC brief; some alteration added).

78. *Id.* at 447.

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.* at 448.

these specific criticisms, the Commission could not "rely on OCC's process totally divorced from any examination of the substance of the Plan."[83]

While "[t]he SEC's lack of reasoned decision-making in assessing the dividend rate [was] enough to make its Order arbitrary and capricious," the D.C. Circuit found more specific problems as well.[84] Although the SEC concluded that the OCC's overall capital target was reasonable, the order "accept[ed] that the target [was] 'appropriately designed' simply because '*OCC represent[ed]* that it used various measures and took a methodical and reasoned approach,'"[85] even though the SEC's ignorance of the consultant that the OCC used for the analysis and the SEC's ignorance of the analysis's content left the Commission in "no position to make a reasoned finding that OCC's process was sound—let alone that the resulting capital target was reasonable."[86] Although the Commission accepted the OCC's claim that the Amended Capital Plan "would not increase fees for customers," that conclusion depended solely on the OCC's statement "that a 'possibly' significant portion of refunds are not passed through."[87]

The Commission seemed to have misunderstood altogether the objection that the Amended Capital Plan discriminated against clearing members by providing that dividends to the Five Contributing Shareholders would continue but refunds to clearing members would cease entirely in the event that the Replenishment Capital was called but not repaid within twenty-four months—as the Commission's order "incorrectly explain[ed] at one point that *both* refunds and dividends [would] end permanently if Replenishment Capital goes unpaid for 24 months."[88] As to the nonshareholder exchanges' complaint that the OCC had violated its own bylaws by late notification to those exchanges that the OCC was considering the Amended Capital Plan, the SEC "merely note[d] that 'OCC represented that it' had 'completed all action required to be taken under its . . . bylaws.'"[89]

After administering these rebukes, the D.C. Circuit concluded that "the SEC may be able to approve the Plan once again, after conducting a proper analysis on remand."[90] Since the plan was already in effect, it would have been logistically difficult to unwind it during the Commission's reconsideration, and the

83. *Id.* The court also rejected the SEC's position that the dividend was fair because it constituted only the excess of fees over actual expenses, and the fees were restrained by projections of those expenses. *Id.* The D.C. Circuit found this "reasoning [to] beg[] the question" of "whether . . . or . . . why . . . it is reasonable to allocate roughly half of unused fees to dividends, as opposed to using a different percentage or a formula other than a fixed proportion of unused fees." *Id.*

84. *Id.* at 449–51.

85. *Id.* at 449 (quoting Order Approving OCC Cap. Plan, *supra* note 62, at 8301 (emphasis added by the court)).

86. *Id.*

87. *Id.* at 449–50 (quoting Order Approving OCC Cap. Plan, *supra* note 62, at 8303 n.127).

88. *Id.* at 450.

89. *Id.* (quoting Order Approving OCC Cap. Plan, *supra* note 62, at 8305). The bylaws provided that the exchanges "be promptly provided with information that [OCC's] Executive Chairman considers to be of competitive significance." *Id.* (quoting Options Clearing Corp., Bylaws Art. VIIB, Interpretations & Policies § 1.01 (amended 2014)).

90. *Id.* at 451.

SEC assured the court that the plan could eventually be unwound if further consideration by the Commission could not save it.[91] The court therefore decided against immediately vacating the SEC's approval order and simply remanded "to give the SEC an opportunity to properly evaluate the Plan."[92]

Significance and analysis. The SEC adopts multiple rules each year and issues orders approving multiple rule changes by SROs.[93] It is inevitable that, in some instances, its processes will prove unsatisfactory. Still, and in light of multiple setbacks in the courts focusing on poor or nonexistent analysis—particularly in the D.C. Circuit[94]—the OCC Capital Plan opinion, with its outright condemnation of the Commission's abdication of responsibility,[95] suggests that some serious quality control efforts are in order.

Disclosure of Interim Financial Figures During an Offering. A company making an initial public offering ("IPO") will use Form S-1 for its registration statement.[96] That form requires inclusion of financial statements conforming to Regulation S-X.[97] Regulation S-X mandates that, if the registration statement includes financial statements that are as of a date 135 days before the effective date of the registration statement or older, the issuer must update the financial numbers, but does not require numbers to update financial statements current within the 135-day period.[98] *Stadnick v. Vivint Solar, Inc*. addressed when an issuer making an IPO has a duty to disclose financial numbers for a quarter ended before the effective date of the registration statement, even though the numbers in that registration statement satisfy the currency requirement of Regulation S-X.[99]

Vivint Solar, Inc. ("Vivint") installed and leased solar panels to residential customers.[100] Its business employed complicated financing through investment funds that were jointly owned by Vivint and investors, with each fund financing a tranche of solar installations and title to the systems transferring to the fund upon installation.[101] The fund then (i) benefited from tax credits and (ii) received most of the customer payments on the systems—until the fund earned a targeted rate of return or the tax benefits timed out—after which the majority of the customer payments went to Vivint.[102] Vivint allocated its income between

91. *Id.*
92. *Id.*
93. *See SEC Final Rules*, U.S. Sec. & Exchange Commission, https://www.sec.gov/rules/final.shtml (last visited Mar. 2, 2018); *Self-Regulatory Organization Rulemaking*, U.S. Sec. & Exchange Commission, https://www.sec.gov/rules/sro.shtml (last visited Mar. 2, 2018).
94. *See* Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011); NetCoalition v. SEC, 615 F.3d 525 (D.C. Cir. 2010); U.S. Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006); U.S. Chamber of Commerce v. SEC, 412 F.3d 133, 143–45 (D.C. Cir. 2005).
95. Susquehanna Int'l Grp., LLP v. SEC, 866 F.3d 442, 443, 446 (D.C. Cir. 2017).
96. 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation § 3:13 (2017) (Form S-1 used by "first-time issuers").
97. Form S-1, Item 11(e) (referring to 17 C.F.R. pt. 210).
98. 17 C.F.R. § 210.3-12(a) & (g)(1)(ii) (2017) (for non-accelerated filers).
99. 861 F.3d 31, 33 (2d Cir. 2017).
100. *Id.*
101. *Id.*
102. *Id.* at 33–34.

the investors in the funds and its own shareholders, and, due to the accounting treatment it employed, "the allocation of income . . . between shareholders and [fund investors could] vary substantially from one quarter to the next depending upon (1) contributions by investors and (2) transfers of title to the funds that provided the requisite capital."[103] Because Vivint generated "a net loss in each quarter during the relevant period," allocating more of the loss to the investors meant allocating less of the loss to Vivint shareholders.[104] But because the investor "losses were occasionally larger than the amount lost by the company as a whole," there were quarters in which "a net positive amount of income" was recognized for shareholders, so that the net loss to fund investors plus the positive income to the shareholders equaled the total loss to the company.[105]

Vivint "issued" its IPO on October 1, 2014.[106] On November 10, 2014, the company released financial results for the third quarter, ending September 30.[107] Those results showed a negative $35.3 million in income to Vivint shareholders during the quarter (-$0.45/share), as opposed to a positive $5.5 million in the previous quarter ($0.07/share).[108] In a 10-Q filed on November 12, the company attributed the results to the timing of title transfers to investment funds.[109] But Vivint's stock price fell nonetheless.[110]

Investors sued Vivint, its CEO and CFO, the other members of its board at the time of the IPO, and the underwriters on the offering, making claims under sections 11 and 12(a)(2) of the Securities Act.[111] On appeal of dismissal, they argued "principally . . . that Vivint was obligated to disclose financial information for the quarter ending one day before the IPO."[112] The Second Circuit's opinion focused on both the proper test for such a duty to disclose and the application of that test.[113]

Since the financial statements in its registration statement were not 135 days or more old, the failure to include the 2014 Q3 figures in that statement did not violate Regulation S-X.[114] To test for an alternative duty to disclose, the district court applied a rule developed by the First Circuit in *Shaw v. Digital Equipment Corp.*, by which an issuer is required—even if the financial numbers in its registration statement meet the currency requirement in Regulation S-X—to disclose later financial figures if they show an "'extreme departure' from previous performance."[115]

103. *Id.* at 34.
104. *Id.*
105. *Id.*
106. *Id.* The SEC declared the registration statement effective on September 30. *See* Vivint Solar, Inc., Notice of Effectiveness (Sept. 30, 2014), https://www.sec.gov/Archives/edgar/data/1607716/999999999514002911/xslEFFECTX01/primary_doc.xml.
107. *Vivint*, 861 F.3d at 34.
108. *Id.* at 34–35.
109. *Id.* at 35.
110. *Id.*
111. *Id.* at 33 n.1, 35.
112. *Id.* at 33.
113. *Id.*
114. *Id.* at 36.
115. *Id.* at 36, 37 (quoting Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1210 (1st Cir. 1996)).

Holding that the *Digital Equipment* test does not apply in the Second Circuit, that court focused on the language of section 11, which imposes liability for, among other things, omitting from a registration statement "a material fact . . . necessary to make the statements therein not misleading."[116] That language, as interpreted by a prior Second Circuit decision that the panel reaffirmed here, uses the "traditional materiality test" to determine whether failure to disclose current quarter financial results renders misleading the older, Regulation S-X–compliant financial numbers in a registration statement.[117]

Applying that test, the Second Circuit concluded that "a reasonable investor would not have viewed Vivint's omission as 'significantly alter[ing] the "total mix" of information made available.'"[118] Vivint's registration statement "contained ample warnings and disclosures that explained shareholder . . . earning fluctuations, namely that: (1) the peculiarities of its business model and the [accounting] method [the company uses] render the metrics identified by [the plaintiff] less probative of Vivint's performance; (2) as a result, the income available for shareholders would likely fluctuate from quarter to quarter; and (3) Vivint anticipated its substantial operating losses to continue."[119] As an alternative to reliance on earnings, the "registration statement identified . . . 'key operating metrics' for assessing the company's performance: (1) system installations, (2) megawatts and cumulative megawatts installed, (3) estimated nominal contract payments remaining, and (4) estimated retained value."[120] And each of those metrics "increased substantially from the second quarter of 2014 to the third and had more than doubled since the second quarter of 2013."[121] Moreover, in light of its financing structure and accounting protocol, the court found the company's total income and total revenue—the aggregate allocated to both Vivint's shareholders and financing funds' investors—"a more accurate indicator of the company's performance" than the income allocated to the shareholders alone (either total income or income per share).[122] Quarter-over-quarter, that revenue increased in the third quarter of 2014, while the net loss also increased ("which comported with the successful implementation of [Vivint's] business model")—continuing a trend that the company had enjoyed in every previous quarter, save one.[123] Put in the context of this "total mix of information," the third quarter shareholder income numbers were not material, and the omission of the Q3 shareholder earnings and earnings per share

116. 15 U.S.C. § 77k(a) (2012); *Vivint*, 861 F.3d at 36. Section 12(a)(2) similarly imposes liability where a prospectus "omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading." 15 U.S.C. 77*l*(a)(2) (2012).

117. *Vivint*, 861 F.3d at 37–38 (referring to DeMaria v. Andersen, 318 F.3d 170, 180 (2d Cir. 2003)).

118. *Id.* at 38 (quoting *DeMaria*, 318 F.3d at 180 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976))).

119. *Id.* at 39.

120. *Id.* at 34.

121. *Id.* at 39.

122. *Id.* at 38.

123. *Id.* Even restricting analysis to income attributable to shareholders and earnings per share, the Q3 2014 results did not break any trend, because there was no trend in those numbers to break. "[N]either variable fluctuated in the same direction for two successive quarters." *Id.* at 39.

"did not render the publicly available information misleading."[124] The Second Circuit affirmed dismissal of the case.[125]

Significance and analysis. *Vivint* warrants two comments. First, the Second Circuit's rejection of *Digital Equipment*'s "extreme departure" test for disclosing interim financial numbers has some appeal. As the court pointed out, that test leaves open such questions 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."[126] And the test could be "counterproductive" if it focuses attention on a single metric without the context of the "total mix" of information available.[127] Moreover, courts are more familiar with the traditional test for materiality that the Second Circuit applied.[128] However, the "extreme departure" test provides some considerable comfort, as counsel can advise that no disclosure is needed unless the interim result is truly "extreme." The Second Circuit hurdle at least seems lower and therefore easier to accidentally violate, thereby possibly generating liability in the public offering context where a violation of section 11 or section 12(a)(2) does not require scienter.[129]

Second, precisely because *Vivint* employs the traditional materiality test, its relevance reaches beyond the interim financial/registration statement context. It is an unusual decision finding that a large change in income attributable to shareholders and a large change in earnings per share were immaterial. That result depended entirely on the issuer's atypical business model and financing structure and an accounting protocol it employed. *Vivint*'s reasoning will not control simply because an issuer asserts that its self-selected "key metrics" are better measures of company performance than earnings included in financial statements that comply with generally accepted accounting principles.

Reg D Rule 508. Securities Act section 5(a) prohibits sale of securities unless the sale is made pursuant to a registration statement that the SEC has declared effective.[130] There are many exemptions from this rule in both the Securities Act and SEC rules.[131] Regulation D contains some of them, set out particularly in its

124. *Id.* at 38. The plaintiff also included in its section 11 claim a charge that Vivint's registration statement "fail[ed] to adequately warn prospective shareholders of the evolving regulatory regime in Hawaii," in violation of Regulation S-K Item 303(a)(3)(ii), 17 C.F.R. § 229.303(a)(3)(ii) (2017). *Vivint*, 861 F.3d at 39. Rejecting this additional portion of the plaintiff's case, the Second Circuit found that the complaint "failed to allege that Vivint's operations in Hawaii were negatively affected by the regulatory changes." *Id.* Moreover, "Vivint's registration statement included repeated warnings that its business was generally vulnerable to changing regulations, and particularly so in Hawaii." *Id.*

125. *Id.* at 40.

126. *Id.* at 37–38.

127. *Id.*

128. *Id.*

129. *See In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1056 (9th Cir. 2014) ("scienter is not an element of either a Section 11 or Section 12(a)(2) claim").

130. 15 U.S.C. § 77e(a) (2012).

131. *See* Gary M. Brown, Securities Law and Practice Deskbook ch. 6 (2017).

Rules 504 and 506, both of which provide exemptions for sales by issuers.[132] Rule 508(a) provides that "[a] failure to comply with a term, condition or requirement of [Rule 504] or [Rule 506] will not result in the loss of the exemption from the requirements of section 5 of the Act for any offer or sale to a particular individual or entity, if the [issuer] relying on the exemption" makes three showings.[133] First, the issuer must show that "[t]he failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity."[134] Second, the issuer must show that "[t]he failure to comply was insignificant with respect to the offering as a whole."[135] Third, the issuer must show that a "good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements of" Rule 504 or 506.[136] Rule 508(b) then states:

> A transaction made in reliance on [Rule 504] or [Rule 506] shall comply with all applicable terms, conditions and requirements of Regulation D. Where an exemption is established only through reliance upon paragraph (a) of this section, the failure to comply shall nonetheless be actionable by the Commission under section 20 of the Act.[137]

Practitioners have interpreted subpart (b) to mean that, while Rule 508 can protect an issuer from claims in private actions under Securities Act section 12(a) for rescission based on the issuer's failure to comply with section 5, the SEC can still bring an action against the issuer for violation of section 5 if the issuer relied solely on Regulation D for an exemption from the registration requirement and the issuer failed to satisfy any term, condition, or requirement of the Regulation D rule on which the issuer relied for registration exemption.[138] The Eleventh Circuit took a different view last year in *SEC v. Levin*, holding that an issuer *can* employ Rule 508 as a defense in a section 5 enforcement action by the Commission.[139]

The SEC sued the defendant for violations of Securities Act sections 5 and 17(a), as well as for violation of Exchange Act section 10(b) and Rule 10b-5.[140] On cross motions for summary judgment, the district court, insofar as the SEC motion was directed to its section 5 claim, initially concluded that the motion should be denied because the defendant relied on Rule 508 to support an exemption and there were genuine issues of fact under that rule going to whether the defendant had made a

132. 17 C.F.R. §§ 230.501–.508 (2017); *id.* §§ 230.504, 230.506. Rule 504(a) states that its exemption applies to "[o]ffers and sales of securities . . . by an issuer. *Id.* § 230.504(a). Rule 506(a) similarly states that the exemptions in that rule apply to "[o]ffers and sales of securities by an issuer." *Id.* § 230.506(a).

133. *Id.* § 230.508(a).

134. *Id.* § 230.508(a)(1).

135. *Id.* § 230.508(a)(2).

136. *Id.* § 230.508(a)(3).

137. *Id.* § 230.508(b).

138. *See* J. William Hicks, Limited Offering Exemptions: Regulation D § 8:4 (2017) ("Rule 508 provides a defense against private actions of rescission for an issuer relying upon Rule 504 . . . or Rule 506 that has failed to comply with certain terms, conditions or requirements of the Regulation. It is not available in enforcement actions by the Commission." (footnotes omitted)).

139. 849 F.3d 995 (11th Cir. 2017).

140. *Id.* at 999.

good faith and reasonable effort to comply with Rule 506 and whether the failure to comply with any provision was significant to the offering as a whole.[141] After the SEC moved for reconsideration, however, the lower court held that Rule 508 did not apply in actions by the Commission at all, and therefore granted summary judgment to the SEC for violation of the registration requirement.[142]

Following a trial after which a jury found the defendant liable for violations of section 17(a) of the Securities Act and section 10(b) of the Exchange Act and Rule 10b-5,[143] the Eleventh Circuit affirmed on those fraud counts but reversed the summary judgment on the registration count.[144] Looking first to the language of Rule 508, the court reasoned that "[g]iven Rule 508(a)'s repeated reference to 'failure to comply' in the context of compliance with the Rules of Regulation D for private offering exemptions, it follows that the phrase 'failure to comply' in Rule 508(b) must be interpreted in the same manner: relating to compliance with Rules 504–506 of Regulation D and not to compliance with Section 5."[145] Moreover, "if the SEC had intended for Rule 508(b) to address non-compliance with Section 5 of the Act, it would have expressly stated so. This is true especially because Rule 508(a), part of the same rule, explicitly references Section 5 of the Securities Act."[146] Finally, the court of appeals concluded that the first sentence of 508(b) would be "superfluous" unless that subsection "is interpreted as allowing the SEC to bring Section 20 enforcement actions for specific violations of the rules of Regulation D, not of Section 5 of the Securities Act, even where Rule 508(a) good faith compliance applies."[147]

Significance and analysis. *Levin*'s interpretation of Rule 508(b) has superficial appeal, but makes little sense. Section 5 contains the registration requirement. Regulation D provides one of a number of exemptions from that requirement.[148]

141. *Id.* at 1002–03. The Eleventh Circuit's opinion suggests that the defendant relied on the exemption in Rule 506(b), which requires that "[e]ach purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." 17 C.F.R. § 230.506(b)(2)(ii). The district court decision found that the offering did not satisfy that exemption because

> at least one purchaser of the . . . notes, Michael Toy, was not an accredited investor nor did he have such knowledge and experience in financial and business matters that he was capable of evaluating the merits and risks of the prospective investment, nor could Levin reasonably believe that he came within this description.

SEC v. Levin, No. 1:12-cv-21917-UU, 2015 WL 11202475, at *6 (S.D. Fla. July 22, 2015). The appellate "record show[ed] that [the defendant] attempted to comply with Rule 506(b)(2) by requiring investors, before purchasing the . . . promissory notes, to submit investor certifications certifying that they were accredited investors under Rule 501, or, if they were not, that they were either sophisticated investors or represented by a 'purchaser representative' as required by Rule 506(b)(2)(ii)." *Levin*, 849 F.3d at 1002–03.

142. *Id.* at 1003.

143. *Id.* at 1000.

144. *Id.* at 998–99, 1005, 1008.

145. *Id.* at 1003.

146. *Id.*

147. *Id.* at 1004.

148. *See supra* note 131.

Choice of a Regulation D exemption is voluntary. It is not required. It is therefore odd to analyze a failure to meet a condition of one of the Regulation D exemptions as a "violation" that would be actionable by the Commission—as opposed to an action by the Commission against the issuer for violating the statute (here section 5) from which Regulation D provides an exemption.

It is also hard to think of appropriate remedies for such a "violation." Would a court enter a conditional injunction, for example, to prohibit failure to provide structured disclosure under Rule 502(b) to purchasers who are not accredited investors, if the defendant in the future made an offering that the defendant planned to be exempt under Rule 506(b)? What if the defendant made such an offering, failed to provide the structured disclosure to purchasers who were not accredited investors, but satisfied the conditions of the exemption from registration in Rule 147A? Would the issuer have run afoul of the injunction? The SEC may need to clarify 508(b), but *Levin* seems a poor interpretation of it.

Insider Trading. Last year brought more cases refining the elements of tipper and tippee liability proscribed by Rule 10b-5.[149] Rule 10b-5 imposes insider trading liability under two theories: the classical theory and the misappropriation theory.[150] The classical theory applies when a corporate insider trades on or tips material nonpublic information that the insider has obtained under circumstances showing that he or she had a duty to use it only for corporate purposes.[151] The misappropriation theory applies when anyone—whether a corporate insider or not—trades on or tips material nonpublic information that he or she obtained from a source to whom the trader or tipper owed a duty of loyalty and confidentiality not to use the information for his or her own purposes.[152]

A tipper violates Rule 10b-5 when he or she passes nonpublic information on to another in violation of a duty not to do so.[153] Under the classical theory, the tipper has violated a duty that he or she owed to the shareholders in the tipper's company.[154] Under the misappropriation theory, the tipper has violated a duty to the source that provided the tipper with the information.[155] Under either theory, tippee liability requires that the tipper violated the relevant duty (to the shareholders of his or her corporation in the case of the classical theory or to the source of information in the case of the misappropriation theory) and that the tippee have the requisite state of awareness of that violation.[156]

A tipper's liability under the classical theory depends on the tipper receiving a personal benefit from the tip.[157] There is "some disagreement about whether benefit to a . . . tipper" is necessary in order that the tip violate the misappropri-

149. *See* Salman v. United States, 137 S. Ct. 420 (2016).
150. United States v. O'Hagan, 521 U.S. 642, 651–53 (1997).
151. *Id.* at 651–52; Chiarella v. United States, 445 U.S. 222, 227 (1980).
152. *O'Hagan*, 521 U.S. at 652.
153. Dirks v. SEC, 463 U.S. 646, 660 (1983).
154. *Id.* at 661–62.
155. SEC v. Obus, 693 F.3d 276, 286 (2d Cir. 2012).
156. *Dirks*, 463 U.S. at 661; *Obus*, 693 F.3d at 287–88 (also necessary under the misappropriation theory).
157. *Dirks*, 463 U.S. at 663.

ation theory.[158] When needed, the requisite "personal benefit can 'often' be inferred 'from objective facts and circumstances,' . . . such as 'a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient.'"[159] And the benefit can be found from a "gift of confidential information to a trading relative or friend."[160]

In 2014, the Second Circuit decided *United States v. Newman*, which made two important holdings regarding "personal benefit," where the tipper provides the material nonpublic information as a gift and the recipient is not a family member but a friend.[161] *Newman* held, first, that the benefit to the tipper must be "objective, consequential, and represent[] at least a potential gain of a pecuniary or similarly valuable nature."[162] It held, second, that an inference of personal benefit from a gift to a friend was "impermissible in the absence of proof of a meaningfully close personal relationship" between the tipper and the tippee; proof of a "casual" acquaintance was not enough.[163] The Supreme Court expressly overruled the first *Newman* holding in *Salman v United States*, where the Court reaffirmed the rule it announced in *Dirks v. SEC* that "when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift . . . because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."[164] But *Salman* involved family members, with the information passing from one brother to another, who passed it to the defendant, who was a brother-in-law.[165] Therefore, *Salman* could be read as leaving *Newman*'s second holding intact.[166]

In 2017, the First Circuit held that, to the extent a "close personal relationship" was needed to sustain a criminal prosecution of a tippee, gifts by the tippee to the tipper's son were sufficient to prove that relationship.[167] However, the Second Circuit, in a two-to-one decision, held that the "close personal relationship" requirement in *Newman* did not survive *Salman*, and that tipping even a non-family member violates Rule 10b-5 if the tipper passes the material nonpublic information on simply with the expectation that the tippee will trade on it.[168]

In *United States v. Bray*, Robert Bray met John O'Neill at a country club.[169] Bray developed real estate, and O'Neill worked at Eastern Bank.[170] As their friendship developed, Bray gave presents to O'Neill's son (a set of golf clubs and a $1,000 check on graduation from high school), helped the son obtain

158. United States v. Bray, 853 F.3d 18, 25 n.4 (1st Cir. 2017) (quoting SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000)) (internal quotation marks omitted).
159. Salman v. United States, 137 S. Ct. 420, 427 (2016) (quoting *Dirks*, 463 U.S. at 664).
160. *Id.* (quoting *Dirks*, 463 U.S. at 664) (internal quotation marks and emphasis omitted).
161. 773 F.3d 438, 452 (2d Cir. 2014).
162. *Id.*
163. *Id.*
164. 137 S. Ct. 420, 428 (2016) (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).
165. *Id.* at 423–24.
166. *See infra* note 183.
167. *See infra* notes 169–96 and accompanying text, particularly at notes 182–86.
168. *See infra* notes 198–214 and accompanying text.
169. 853 F.3d 18, 22 (1st Cir. 2017).
170. *Id.*

an internship with an architect, and provided a reference for a job at a restaurant.[171] Bray sought investment advice from O'Neill, and O'Neill provided the names of small banks that, based on public information, were likely targets for takeovers.[172]

On June 13, 2010, Bray told O'Neill that he (Bray) "needed to make a 'big score'" in order to finance a real estate venture called the Watertown Project.[173] At one point in the ensuing conversation,

> O'Neill . . . took a napkin, penned the word "Wainwright" on it, and slid it across the bar toward Bray. As he did so, O'Neill told Bray that "[t]his could be a good one," or at least "something to that effect." Bray wordlessly took the napkin, slipped it into his pocket, and did not mention or ask about its contents for the rest of the night.[174]

At the time, O'Neill was performing due diligence on the Wainwright bank because it was a potential takeover target, and O'Neill had signed a confidentiality agreement covering the due diligence work.[175]

Beginning on the next day and continuing for two weeks, Bray bought Wainwright stock, with money largely generated by selling stocks in his current portfolio, so that at the end of the buying (during which Bray's purchases constituted 56 percent of total trading in Wainwright shares), that stock comprised about 57 percent of Bray's total securities holdings.[176] After the bank at which O'Neill worked announced an agreement to buy Wainwright for about double the pre-agreement price, Bray sold the stock for a profit approximating $300,000.[177] On two occasions thereafter, Bray offered to let O'Neill invest in the Watertown project, on the second occasion offering the investment for no payment.[178] During ensuing investigations, O'Neill told Bray that he (O'Neill) "could 'lose [his] job over this,'" Bray told O'Neill that he (Bray) "had not 'told anybody' about the tip," and Bray falsely told the SEC that O'Neill had not tipped and that he (Bray) bought the Wainwright stock because of its dividends and environmental policies.[179]

Affirming Bray's conviction for insider trading on a tip under the misappropriation theory,[180] the First Circuit addressed three issues.[181] First, the court found sufficient evidence to support the jury verdict on the element that O'Neill "gave Bray the Wainwright tip with the 'purpose' of obtaining a personal benefit."[182]

171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.* at 22–23.
175. *Id.* at 23.
176. *Id.*
177. *Id.*
178. *Id.* at 23–24 & n.3, 28.
179. *Id.* at 24.
180. *Id.* at 22, 25, 31.
181. *Id.* at 26–31.
182. *Id.* at 26. The court declined to resolve the disagreement over whether a tipper under the misappropriation theory must receive or expect a personal benefit, *see supra* note 158 and accompanying text, because "there was enough evidence such that a reasonable jury could conclude beyond a reasonable doubt that O'Neill disclosed the Wainwright tip in expectation of [such a] benefit." *Id.* at 25 n.4.

As described above, the Supreme Court wrote in 1983 that gifting material non-public information to a "friend" provided a sufficient benefit to the tipper to satisfy the personal benefit element, the Second Circuit had held in 2014 that tipping a "casual acquaintance" was not enough.[183] Here the evidence—including the gifts from Bray to O'Neill's son—provided at least a plausible basis for the jury finding a sufficiently close relationship to find a benefit, or expected benefit, from the tip.[184] Moreover, the gifts to the son "demonstrated that Bray knew O'Neill well enough to extend favors to O'Neill's extended family," and O'Neill testified that "he 'figured [the tip] would enhance' his reputation with Bray [so that, w]hile O'Neill 'did not expect anything at the exact time' he gave Bray the tip, a reasonable jury could infer that he expected a benefit 'down the road.'"[185] Bray's later offer to give O'Neill a free investment in Watertown "show[ed] that these expectations were warranted."[186]

Second, the court of appeals found sufficient evidence to support a jury finding that Bray both had the requisite understanding that (i) O'Neill was breaching a duty when passing on the information that buying Wainwright would be profitable and (ii) O'Neill expected a personal benefit from Bray for doing so.[187] While the Supreme Court had held that the element of tippee understanding of the tipper's breach means that "the tippee knows *or should know* that there has been a breach,"[188] lower courts have characterized the element in criminal cases as that the tippee "knew" of the breach.[189] Both the government and Bray "seemingly assumed" that the higher standard applied (and the court so held, as set out below), and the First Circuit found sufficient evidence to support a jury finding that Bray both "*knew* [that] O'Neill had breached a duty of confidentiality by giving him the Wainwright tip" and "*knew* O'Neill tipped him in expectation of a personal benefit."[190] As to the first sufficiency finding, "[t]hough O'Neill did not tell Bray that he was working on the Wainwright acquisition, Bray knew what O'Neill did for a living and, presumably, that O'Neill had evaluated potential acquisition targets in the past," and the "surreptitious manner" in which O'Neill slipped Bray the Wainwright information on the napkin supported the notion that Bray knew O'Neill was doing wrong when he did so.[191] Further, "when

183. *Id.* at 27 (quoting United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014)) (internal quotation marks omitted). The First Circuit recognized that *Salman* overruled *Newman* to the extent that *Newman* held that the personal benefit must be "objective, consequential, and represent[] at least a potential gain of a pecuniary or similarly valuable nature." *Id.* at 26 n.5 (quoting *Newman*, 773 F.3d at 452) (internal quotation marks omitted). But the First Circuit concluded that *Salman* "does not foreclose Bray's argument" that *Newman* correctly held a friendship must be "meaningfully close" in order that a gift to the friend generate the requisite benefit to the tipper. *Id.* (quoting *Newman*, 773 F.3d at 452).

184. *Id.* at 27.

185. *Id.* (quoting O'Neill's testimony).

186. *Id.*

187. *Id.* at 27–29.

188. Dirks v. SEC, 463 U.S. 646, 660 (1983).

189. *Bray*, 853 F.3d at 28 n.6.

190. *Id.* at 28 & n.6 (emphasis added).

191. *Id.* at 28.

O'Neill went to Bray with news of the FINRA inquiry [into trading just before the acquisition announcement], Bray did not act surprised when he 'learned' that the tip stemmed from nonpublic information or think to ask why O'Neill had given him a tip in breach [of] his duty of confidentiality. Instead, Bray's first instinct was to assure O'Neill that he had not told anyone about the tip and to develop a cover story."[192] As to the second sufficiency finding, the evidence set out above respecting the relationship between the two sufficed for the jury to conclude that "though Bray may not have known the exact benefit O'Neill sought in exchange for the tip," he "knew O'Neill sought a personal benefit in exchange for the tip," as Bray's offer of a free interest in Watertown confirmed.[193]

Third, in responding to Bray's argument that the district court had erred by instructing the jury that—as to the element of Bray's awareness of O'Neill's breach of duty—it sufficed that Bray "'knew or . . . should have known' that O'Neill had breached a duty of confidentiality by giving him the Wainwright tip," the First Circuit agreed that "the district court clearly erred by including the 'should have known' language in its jury instructions."[194] At least in a criminal case, "the 'knew or should have known' formulation runs up against a decades-long presumption that the government must prove that the defendant knew the facts that made his conduct illegal."[195] Since Bray had not objected to the instruction at trial, however, the court of appeals applied the plain error standard and did not reverse; the error did not distort the fairness or integrity of the jury verdict because "the government presented ample evidence that Bray knew O'Neill had breached a duty of confidentiality by tipping, or at least possessed the requisite 'culpable intent.'"[196]

The First Circuit decided *Bray* on the assumption that *Salman* left open the argument that, in order for a gift to a friend to generate the requisite benefit to the tipper, the friendship must be "a meaningfully close personal relationship."[197] In a more adventurous decision, the Second Circuit held in *United States v. Martoma* that *Salman* renders "no longer good law" at all the *Newman* requirement for a "close personal relationship" between a tipper and a tippee who are not in the same family.[198]

Martoma worked as a portfolio manager at S.A.C. Capital Advisors, LLC ("SAC"), headed by Steven Cohen.[199] SAC paid an expert networking firm that, in turn, paid consultants who met with Martoma.[200] Through this consulting arrangement, doctors involved with the clinical trials of a drug being devel-

192. *Id.* at 28–29.
193. *Id.* at 28; *see supra* notes 184–86 and accompanying text.
194. *Id.* at 29.
195. *Id.* at 29–30 (quoting United States v. Parigian, 824 F.3d 5, 11 (1st Cir. 2016)) (some internal quotation marks omitted).
196. *Id.* at 30–31 (quoting *Parigian*, 824 F.3d at 11).
197. *See supra* note 183.
198. 869 F.3d 58, 69 (2d Cir. 2017).
199. *Id.* at 61.
200. *Id.* at 61 n.1.

oped by Elan Corporation, plc ("Elan") and Wyeth provided information about the trials to Martoma, in violation of the doctors' confidentiality obligations, including in a meeting by one doctor with Martoma shortly after that doctor determined that the clinical trial data had "two major weaknesses."[201] Two days later, and after Martoma spoke with Cohen, SAC—which held stock in both drug companies—began selling Elan and Wyeth short and buying options to protect against declines in those stocks.[202] After the doctor made a public presentation about the clinical results, Elan's share price declined by 42 percent and Wyeth's by 12 percent.[203] The protective trades that SAC made after Martoma met with the doctor and before the public announcement of the clinical results brought SAC $80.3 million in profits and avoided $194.6 million in losses.[204]

The doctor received no consulting fee for the particular meeting and related phone conversation during which he previewed the data problems to Martoma, because the doctor submitted no bill for those communications precisely in order to avoid implicating himself as a tipper.[205] But the doctor had many other consulting meetings for which he did bill, since he "participated in approximately 43 consultations with Martoma at the rate of around $1,000 per hour."[206] The Second Circuit, in affirming Martoma's conviction,[207] reasoned that since the doctor "regularly disclosed confidential information in exchange for fees," a rational fact finder could have found that the doctor benefited from the particular tip "'under a pecuniary quid pro quo theory.'"[208]

The trial court, however, had instructed not only that the doctor must have received a personal benefit but that "[t]he benefit may, but need not be, financial or tangible in nature; it could include obtaining some future advantage, developing or maintaining a business contact or a friendship, or enhancing the tipper's reputation."[209] On appeal, and relying on *Newman*, Martoma challenged that instruction on the ground that it did not include the qualification that personal benefit based on friendship required proof that the tipper and tippee had a "meaningfully close personal relationship" but instead told the jury that it could convict if the doctor tipped simply to develop any friendship.[210] The *Martoma* majority rejected this challenge, reasoning that the straightforward analysis confirmed by *Salman*—that "[i]f the [tipper] discloses inside 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,' [the

201. *Id.* at 62.
202. *Id.*
203. *Id.*
204. *Id.*
205. *Id.* at 67.
206. *Id.* at 61.
207. The jury found Martoma guilty of two counts of conspiracy to commit securities fraud and two counts of securities fraud under Exchange Act section 10(b). *Id.* at 61; *see id.* at 61, 73–74 (majority affirming).
208. *Id.* at 66–67 (citing United States v. Coplan, 703 F.3d 46, 62 (2d Cir. 2012)).
209. *Id.* at 64 (quoting instruction).
210. *Id.* at 64–65, 73.

tipper] personally benefits"[211]—requires no close personal relationship but only an expectation by the tipper that the tippee will trade.[212]

All of this, however, had no effect on the decision because Martoma had not challenged the instruction in the lower court.[213] Even if the instruction had been erroneous, it "did not impair Martoma's substantial rights in light of the compelling evidence that [the doctor], the tipper, received substantial financial benefit in exchange for providing confidential information."[214]

Significance and analysis. The courts' concentration on the personal benefit element from tips to non-family members seems strange in the *Bray* and *Martoma* cases. In each, the prosecution seems to have shown that the tipper at least expected a pecuniary benefit from the tip at the time the tipper passed the information—something that does not require a "gift to a friend" motivation at all. The *Bray* and *Martoma* decisions admit as much.[215] The unnecessary intellectual effort seems generated by a notion that somehow *Dirks* might permit the psychological satisfaction of gift giving to suffice for the personal benefit *Dirks* requires and that such psychological satisfaction—outside the setting in which one family member passes material nonpublic information to another—is unlikely unless the tipper has a close personal relationship with the tippee.

Manipulation. In *City of Providence, Rhode Island v. Bats Global Markets, Inc.*, institutional investors sued national securities exchanges, alleging that the exchanges violated Rule 10b-5 by misleading them "about certain products and services that the exchanges sold to high-frequency trading ("HFT") firms, which purportedly created a two-tiered system that favored those firms at the plaintiffs' expense."[216] The investors focused on three exchange services.[217] First, the investors alleged that the exchanges provided proprietary data feeds to the HFT firms, at prices prohibitive for even institutional investors like the plaintiffs, and that the proprietary feeds provided extra details on trades and reached the HFT firms faster than the trade information that was economically

211. *Id.* at 69–70 (quoting Salman v. United States, 137 S. Ct. 420, 428 (2016); Dirks v. SEC, 463 U.S. 646, 6604 (1983)) (citation omitted).

212. *Id.* at 70.

213. *Id.* at 66.

214. *Id.* at 73. For the same reason—because "the evidence presented at Martoma's trial was sufficient to convict under a straightforward pecuniary benefit theory"—the Second Circuit concluded that it "need not consider the outer boundaries of when a jury is entitled to infer, relying on circumstantial evidence, that a particular disclosure was made 'with the expectation that [the] recipient would trade on it,' and 'resemble[d] trading by the insider followed by a gift of the profits to the recipient.'" *Id.* at 72 (quoting *Salman*, 137 S. Ct. at 428; *Dirks*, 463 U.S. at 664) (citation omitted).

The *Martoma* panel divided two to one. The dissenter argued that removing the close personal relationship requirement "strips the long-standing personal benefit rule of its limiting power." *Id.* at 75 (Pooler, J., dissenting). In addition, her review of *Salman* found "no disapproval of the 'meaningfully close personal relationship' language in *Newman*." *Id.* at 80. As she read the decision, the Supreme Court had declined to adopt the broad view advanced by the government "that 'a gift of confidential information to anyone, not just a "trading relative or friend," is enough to prove securities fraud.'" *Id.* at 81 (quoting *Salman*, 137 S. Ct. at 426).

215. *See supra* notes 184–86, 208 and accompanying text.

216. 878 F.3d 36, 40 (2d Cir. 2017).

217. *Id.* at 41–42.

available to the plaintiffs.[218] With the more detailed information they received and the greater speed with which it came to them, the HFT firms were, allegedly, able to "front-run" other market participants[219]—by "anticipating when a large investment [in] a given security [was] about to be made, purchasing shares of the security in advance of the investment, and then selling those shares to the buying investors at slightly increased prices."[220] Second, the plaintiffs claimed that the exchanges offered co-location to HFT firms—which like the proprietary feeds, was too expensive for other traders—allowing the HFT traders "to place their computer services in close physical proximity to the exchanges' systems," which like the proprietary feeds gave those firms "access [to] and [therefore the ability to] trade on information before it [became] publicly available."[221] Third, the investors asserted that the exchanges offered the HFT traders "complex order types" involving "pre-programmed, electronic commands"[222]—for example, "'hide and light' orders that allow[ed those] traders to place orders that remain[ed] hidden from the ordinary bid-and-offer listings on an individual exchange until a stock reache[d] a particular price, at which point the hidden orders emerge[d] and jump[ed] the queue ahead of other investors' orders."[223]

The investors contended that the exchanges had, by these services, manipulated within the meaning of section 10(b) and violated Rule 10b-5 because the exchanges had deceived the investors "into believing that prices at which they purchase[ed] and [sold] securities [were] determined by the natural interplay of supply and demand" rather than at prices "'rigged'" by HFT trading.[224] The exchanges, the plaintiffs alleged, "failed to disclose the full impact that such products and services would have on market activity and knowingly created a false appearance of market liquidity that, unbeknownst to plaintiffs, resulted in their bids and orders not being filled at the best available prices."[225]

Reversing the district court's judgment dismissing the complaint,[226] the Second Circuit provided four holdings.[227] First, the court of appeals held that the district court had jurisdiction.[228] The defendants contended that "the subject matter . . . [was] within the SEC's regulatory purview" because the plaintiffs were "actually challenging the SEC's determination that proprietary data feeds, co-location services, and complex order types are consistent with the Exchange Act and Regulation NMS," and that "such a challenge must be resolved by the

218. *Id.* at 42. As to speed, the exchanges *released* the data at the same time to all, but the plaintiffs experienced some delay in *receipt* of it because it came to them through aggregator intermediaries, whereas the propriety feeds provided the information directly to the HFT firms. *Id.*

219. *Id.*

220. *Id.* at 41.

221. *Id.* at 42–43.

222. *Id.* at 43.

223. *Id.*

224. *Id.* at 49 (quoting Gurary v. Winehouse, 190 F.3d 37, 45 (2d Cir. 1999)).

225. *Id.*

226. *Id.* at 40, 52.

227. *Id.* at 44–52.

228. *Id.* at 44–45.

SEC in the first instance."[229] But, while "NMS Rule 608(d) allows the SEC to 'entertain appeals in connection with the implementation or operation of any effective national market system plan,'"[230] the "[p]laintiffs challenge[d] particular actions taken by the defendants individually and not as part of a 'national market system plan' that enables joint action by multiple exchanges."[231] Therefore, their "claims [were] not a challenge to the SEC's general authority or an attack on the structure of the national securities market" but, the Second Circuit ruled, simply fraud claims against the exchanges that were properly brought under Exchange Act section 27.[232]

Second, the court of appeals ruled that the exchanges were not immune from the plaintiffs' claims.[233] The exchanges are self-regulatory organizations ("SROs") that are "non-governmental entities that function both as regulators and regulated entities."[234] While they are immune from suit when they act in their regulatory capacity,[235] "the provision of co-location services and proprietary data feeds does not relate to the exchanges' regulatory function and does not implicate the SROs' need for immunity."[236] And even the exchanges conceded that "complex order types are 'preprogrammed commands *traders* use to tell the *Exchanges* how to handle their bids and offers'—not regulatory commands by the exchanges compelling traders to behave in certain ways."[237]

Third, the Second Circuit held that the plaintiffs stated a cause of action.[238] The complaint "sufficiently [pled] that the exchanges misled investors by providing products and services that artificially affected market activity."[239] That sufficed for manipulation.[240] Rejecting the exchanges' argument that they did not manipulate because they, themselves, did not trade, the court found no "authority explicitly stating that such a [manipulation] claim must concern a *defendant's* trading activity," and the complaint alleged the exchanges "manipulated market activity" by leading plaintiffs to believe that the prices at which they bought and sold securities were determined solely by market forces.[241] The court also ad-

229. *Id.* Congress established "a unified 'national [securities] market system.' ('NMS'). *See* 15 U.S.C. § 78k-1(a)." *Id.* at 41. The SEC issued "a series of regulations, culminating in 2005 with Regulation NMS, 'to modernize and strengthen the national market system . . . for equity securities.' Regulation NMS, 70 Fed. Reg. 37,496, 37,496 (June 29, 2005) (codified at 17 C.F.R. § 242.600 et seq.)." *Id.*

230. *Id.* at 45 (quoting 17 C.F.R. § 242.608(d)).

231. *Id.*

232. *Id.*; 15 U.S.C. § 78aa(a) (2012).

233. *City of Providence*, 878 F.3d at 45–48.

234. *Id.* at 40.

235. *Id.* at 46.

236. *Id.* at 47.

237. *Id.*

238. *Id.* at 48–50.

239. *Id.* at 49.

240. *Id.*

241. *Id.* at 50 (emphasis added). While the exchanges also contended that they committed no fraud because they disclosed their conduct to the public and the SEC, the court found that the "plaintiffs concede[d] that the exchanges may have told ordinary investors about the *existence* of proprietary data feeds and co-location services, but assert that the exchanges did not publicly disclose the full range or cumulative effect that such services would have on the market, the trading public, or the prices of securities" and pled that "that the exchanges did not disclose, or selectively disclosed, complex order types." *Id.* While the exchanges "contested" the charge that they had not adequately re-

dressed the possibility that SEC approval of the exchanges' practices defeated the plaintiffs' claims, noting that "although the SEC has approved proprietary data feeds, co-location services, and complex order types under certain circumstances, it has challenged them under other circumstances," and finding it "not clear based on the pleadings whether or to what extent the SEC has sanctioned the defendants' conduct regarding the particular products and services in the instant case."[242]

Fourth, the Second Circuit disagreed with the district court's reasoning that at most the exchanges aided and abetted manipulation by the HFT firms—which would have required dismissal because there is no private cause of action against a Rule 10b-5 aider and abettor.[243] As the court of appeals saw it, "the plaintiffs contend that the exchanges were co-participants with HFT firms in the manipulative scheme and profited by that scheme," with the exchanges' part in the fraud consisting of "'falsely reassur[ing] ordinary investors that their "fair and orderly" trading platforms provided "transparent trading" where all investors received market data in "real time,"' when instead they had misrepresented and omitted critical information about products and services they were providing and had purposefully created a 'two-tiered market' in which plaintiffs were 'at an informational disadvantage.'"[244] This was enough to plead that the exchanges were primary violators that "committed manipulative acts and participated in a fraudulent scheme in violation of the Exchange Act and Rule 10b-5."[245]

Significance and analysis. The opinion is odd. On the one hand, it is centered on market manipulation. On the other hand, the claim against the exchanges is that they either, or both, made misrepresentations or misled by omissions. It is hard to see how the exchanges were more than aiders and abettors in the manipulation, but easy to see how they were primary violators with respect to their own alleged misrepresentations and misleading statements. Essentially, it was a case about misrepresentations by the exchanges concerning manipulation by the HFT firms. The court's failure to sort this out—which is most glaring in the court's primary violator analysis, which simply says that the misrepresentations or omissions were part of the manipulation—is unsettling.

Scienter and Scienter Pleading. To commit a Rule 10b-5 violation, a defendant must have scienter when making a false statement or taking other action that deceives.[246] Scienter encompasses both an intent to deceive[247] and severe recklessness, most often defined as "highly unreasonable" conduct "involving not merely simple, or even inexcusable negligence, but an extreme departure

vealed the challenged practices, the court, at the pleading stage, accepted the allegations in the complaint as true and drew inferences in favor of the plaintiffs. *Id.*

242. *Id.*

243. *Id.* at 51–52.

244. *Id.* at 51. The investors alleged that "the exchanges received hundreds of millions of dollars in payments for those products and services and in fees generated by the HFT firms' substantially increased trading volume on their exchanges." *Id.*

245. *Id.* at 52.

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

247. *Id.* at 194 n.12.

from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the [defendant] must have been aware of it."[248] A special statutory pleading requirement demands that a private plaintiff pursuing a Rule 10b-5 action for damages plead facts raising a "strong inference" that a defendant had scienter.[249] In determining whether a complaint meets this standard, a court should weigh competing pejorative and benign inferences from the pled facts and find that the complaint meets the "strong inference" test only if, after doing so, the inference of scienter is "cogent and at least as compelling as any opposing inference of nonfraudulent intent."[250]

The Fourth Circuit last year affirmed dismissal of a complaint seeking recovery under Rule 10b-5, holding that it pled a statement was false, alleged the speaker knew it was false, but yet—in the court's view—failed to adequately include facts raising a strong inference of scienter.[251] The Ninth Circuit concluded scienter allegations failed because a complaint failed to establish the needed chronological sequence between a bank's knowledge of regulator criticisms and statements that the bank made that its operations were "safe and sound."[252] The Fifth Circuit found scienter pleading inadequate where the issuer's CFO made statements about the production of a particular oil well, even though the complaint alleged that an attachment to an email sent to the CFO showed that the production was lower.[253]

In the list of Rule 10b-5 elements, scienter is separate from falsity,[254] and a Fourth Circuit decision in 2017 depended on that separation. In *Maguire Financial, LP v. PowerSecure International, Inc.*, the issuer provided infrastructure products and services to utility companies.[255] In mid-2013, its contract with Florida Power & Light ("FP&L") was coming to an end.[256] On June 6, 2013, the company issued a press release referring to a $75 million increase in its revenue

248. All circuits have held that some form of recklessness suffices for scienter. VIII Louis Loss, et al., Securities Regulation 170–85 & n.555 (5th ed. 2017). The definition of recklessness set out in the text derives from *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044–45 (7th Cir. 1977). Most circuits employ it. VIII Loss, *supra*, at 188 & n.558.

249. 15 U.S.C. § 78u-4(b)(2)(a) (2012) ("the complaint shall, with respect to each act or omission alleged to violate [the Exchange Act], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"). That state of mind, for a Rule 10b-5 claim, is scienter. *See supra* notes 246–48 and accompanying text. But, for forward-looking statements protected by the Exchange Act, the plaintiff must allege "facts that g[i]ve rise to a 'strong inference' that [the defendant] had 'actual knowledge' that [the] projections [or other forward-looking statements] were false or misleading." *See* IBEW Local No. 58 Annuity Fund v. EveryWare Global, Inc., 849 F.3d 325, 327 (6th Cir. 2017) (affirming dismissal, *id.* at 328, where plaintiffs failed to do so).

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

251. *See infra* notes 254–76 and accompanying text.

252. *See infra* notes 279–87 and accompanying text.

253. *See infra* notes 288–313 and accompanying text.

254. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341 (2005) (separately listing the Rule 10b-5 elements to include: "(1) a material misrepresentation (or omission); (2) scienter, i.e., a wrongful state of mind . . . ." (citations omitted)).

255. 876 F.3d 541, 544 (4th Cir. 2017), *petition for cert. filed*, No. 17-1303 (U.S. Mar. 12, 2018).

256. *Id.*

backlog, "including approximately $49 million from a renewed and expanded three[-]year utility infrastructure award to serve one of the nation's largest investor owned utilities."[257] More critically for the case, during an August 7 analyst conference call, the CEO announced "securing a $49 million three-year contract renewal, both the renewal and expansion with one of the largest investor[-owned] utilities in the country."[258]

In fact, while the company—under its old contract with FP&L—provided service to the West Palm Beach area, the company would provide service under a new contract to the Fort Myers area.[259] Due to the distance between the two service areas, the company had to hire an entirely new work force.[260] Thus, "[a]lthough the new contract offered [the company] more work, its higher costs reduced short-term profitability."[261] The company therefore reported a first quarter 2014 loss on May 7, 2014, and the price of its stock dropped more than 62 percent.[262]

The plaintiff brought a Rule 10b-5 action against the company and the CEO,[263] who had participated in the energy industry for about thirty years.[264] The plaintiff contended "that 'it is impossible that [the CEO] did not know the contract was *not* a renewal but, instead, was an entirely new contract for a different geographic area' that would require the company to hire and train new workers 'at considerable expense.'"[265] Affirming dismissal, the Fourth Circuit held that "an inference . . . [the CEO] may have known his statement was false does not alone satisfy the scienter requirement."[266] The court also rejected the equation of "an inference that [the CEO] knew enough to realize that his characterization was technically incorrect" with "an inference that he intended it to deceive."[267] The Fourth Circuit further found unpersuasive the argument that an investor's perspective supported an inference that the CEO intended to deceive because "[a] reasonable investor might well expect a seasoned executive like [the CEO] to know the difference between a contract renewal and expansion and intend to make the distinction."[268] The court reasoned that "an investor's view of a statement is not itself evidence of the speaker's state of mind."[269]

The Fourth Circuit offered a pastiche of rationales for its decision that a knowing falsehood might be uttered without scienter. A general precept holds that "[a]

257. *Id.* (quoting press release) (abbreviations omitted).
258. *Id.* (quoting CEO).
259. *Id.* at 545.
260. *Id.*
261. *Id.*
262. *Id.* at 544–45 (with cost of sales increasing by 34% and operating expenses by 39%).
263. *Id.* at 545–46.
264. *Id.* at 544.
265. *Id.* at 547 (quoting plaintiff) (emphasis added by the court).
266. *Id.* at 547, 551.
267. *Id.* at 548 (also saying: "An inference that an executive had enough knowledge to be aware that he was making an inaccurate statement might support an inference that he made a material misrepresentation but does not necessarily suggest an intent to mislead.").
268. *Id.*
269. *Id.*

plaintiff may not stack inference upon inference to satisfy the [Exchange Act scienter] pleading standard," and the court found that principle to apply here, where the plaintiff "allege[d] facts that permit an inference that [the CEO] knew his statement was false, and then asks us to *infer from that inference* that [the CEO] acted with scienter."[270] Declining that invitation, the court ruled that the plaintiff had to "show that [the CEO] affirmatively sought to advance [a false narrative] or calculatedly sought to obscure . . . reality."[271] Turning to the exact words the CEO used, the court noted that he "never specified that the West Palm Beach contract had been extended or that [the company] would continue to serve West Palm Beach."[272] And his phrase "renewal and expansion" "embrace[d] the possibility that the new contract was not a renewal on identical terms."[273] Moreover, the circumstance that the complaint "fail[ed] to identify a single fact that shows that [the CEO] knew on August 7, 2013, that the new contract would be less profitable is a serious deficiency."[274] While the plaintiff argued that it was impossible for the CEO to be unaware of the costs that would be added by moving the contract coverage from one area to another one distant from the first, the Fourth Circuit found this "far from intuitive," and noted that the CEO commented in May 2014, when announcing the first quarter 2014 loss, "that 'we probably underestimated the negativity [and] the complexity of basically starting from scratch in a new territory.'"[275] Putting a quantitative touch on its analysis, the court added its reluctance "to infer that [the CEO] knew in advance that the contract would be less profitable given the fact that the FP&L contract historically accounted for only 4.1 percent of the company's annual revenue and without facts to suggest that anyone should have known of this risk."[276]

The Exchange Act includes not only the special pleading rule for scienter but also one for falsity—requiring that a complaint "shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[277] For this purpose, allegations based on investiga-

270. *Id.*

271. *Id.* (remarking also that "[t]he facts presented here highlight the reason for cabining misrepresentation and scienter within their respective domains").

272. *Id.* at 549.

273. *Id.* at 549–51.

274. *Id.* at 549.

275. *Id.* at 549–50.

276. *Id.* at 550 (adding: "Even if someone at [the company] believed that a contract for Ft. Myers would cause the company to incur additional costs, no fact alleged suggests that [the CEO] was this person."). The court also brushed aside alleged stock sales offered to support a scienter inference, concluding that the company's sale of stock gave the defendants only a "generalized motive" to keep the stock price high that was "scarcely sufficient, standing alone, to suggest impropriety." *Id.* at 551. As for the CEO's stock sales and transfers, "[h]e did not sell his shares when their value was highest" and his "transfer of shares to his wife occurred some months after the August 7, 2013, statement in connection with their impending divorce." *Id.* at 551. These financial moves did not create an "inference of scienter 'strong in light of other explanations.'" *Id.* (quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007)).

277. 15 U.S.C. § 78u-4(b)(1) (2012).

tion of counsel are made on "information and belief."[278] In 2017, the Ninth Circuit found a complaint to violate this standard as well as the special pleading standard for scienter, with both failures related to the chronological relationship between a government report, the events described in that report, the issuer's knowledge of the contents of the report, and the issuer's statements.

The plaintiff in *City of Roseville Employees' Retirement System v. Sterling Financial Corp.* brought a Rule 10b-5 claim against Sterling Financial Corp. ("Sterling"), alleging that it committed fraud by "statements assuring investors of its 'safe and sound' banking practices."[279] Sterling made the last such statement on July 23, 2009.[280] The plaintiff rested its contention that those statements were knowingly false largely on a cease and desist order ("CDO") entered by the Federal Deposit Insurance Corporation ("FDIC") and the Washington State Department of Financial Institutions ("DFI") that Sterling disclosed on October 15, 2009.[281] That "CDO reflected the FDIC and DFI's determination 'that they had reason to believe that [Sterling] had engaged in unsafe or unsound banking practices and violations of law and/or regulations.'"[282] The CDO in turn referred to a June 2009 report.[283]

The Ninth Circuit affirmed dismissal on two grounds: failure to plead falsity and failure to adequately allege scienter.[284] Both depended on timing. As to falsity, the CDO did "not establish that Sterling engaged in unsafe and unsound practices *at the time* the statements were made."[285] Thus, even the reference to the June 2009 report did "not establish Sterling continued to engage in unsafe and unsound practices until July 23, 2009, when the final 'safe and sound' statement was made."[286] As to scienter, the complaint contained insufficient allegations to support a strong inference that Sterling or the individual defendants intended to deceive at the time they made the challenged statements. In particular, "there is no allegation that Sterling received the June 2009 Report detailing violations before Sterling made its last statement."[287]

278. *See, e.g.*, Adams v. Kinder-Morgan, Inc., 340 F.3d 1083, 1097–98 (10th Cir. 2003). Accordingly, in a class action, where the named investor serving as plaintiff will have no personal knowledge of the facts showing a statement to have been false, the allegations bearing on falsity will emerge from investigation by the plaintiff's counsel and will be, therefore, on information and belief.

279. 691 F. App'x 393, 395 (9th Cir. 2017).

280. *Id.* at 395; City of Roseville Emps.' Ret. Sys. v. Sterling Fin. Corp., 963 F. Supp. 2d 1092, 1119–20 (E.D. Wash. 2013).

281. *Sterling Fin.*, 963 F. Supp. 2d at 1103–04.

282. *Id.* at 1103.

283. *Sterling Fin.*, 691 F. App'x at 395.

284. *Id.* at 394, 396.

285. *Id.* at 395.

286. *Id.* This begged the question of whether reference to the June report sufficiently pled that Sterling's earlier statements were false. The district court addressed that issue so: "*The CDO only indicates what the FDIC believed at the time it issued the CDO*; it does not reflect a finding about whether Defendants previously engaged in unsafe and unsound practices, when such practices began, or for how long Defendants were engaged in such practices." *Sterling Fin.*, 963 F. Supp. 2d at 1121.

287. *Sterling Fin.*, 691 F. App'x at 396. And the circumstantial evidence—such as that "Sterling's knowledge that regulators were present at the bank [and] confidential witness four's ('CW4') testimony that regulators communicated findings of unsafe and unsound practices to Sterling"—did not show that CW4 had "personal knowledge of what Sterling executives knew or were specifically told by the regulators." *Id.* at 395–96.

As a final 2017 opinion addressing scienter outside the life sciences sector discussed below, a decision from the Fifth Circuit considered the extent to which the element can hinge on data deep inside an attachment to an email. After ATP Oil & Gas Corporation ("ATP") filed for bankruptcy on August 17, 2012, shareholders brought a Rule 10b-5 case against its former top executives.[288] The investors alleged that (i) the former CFO fraudulently stated in August 2011 that Well #4 had "delivered on ATP's original expectations with an initial rate exceeding 7,000 Boe [barrels of oil equivalent] per day" and, both then and on September 12, 2011, that ATP was producing 31,000 Boe per day or more;[289] (ii) defendants misrepresented in various statements from 2010 to 2012 that ATP had sufficient liquidity to meet its needs, including capital to construct a pipeline to connect wells in the Gulf of Mexico to an oil production platform;[290] and (iii) defendants provided a false and misleading reason for the resignation by a new CEO, who apparently quit within a week of being hired.[291]

Affirming on the ground that the complaint did not adequately plead scienter,[292] the Fifth Circuit reasoned that, since ATP disclosed in November 2011 that Well #4 was producing only 3,500 Boe daily, that admission—"just two months after [the CFO's] statements"—"belies an inference of scienter" because "it would have made little sense for [the CFO] to lie about Well #4's production in September only to have [the company president] disclose the true production in November."[293] This was particularly so because the plaintiffs did "not allege[] that [the CFO] had a particular reason to lie in September that would have vanished by November."[294] Although the complaint reported a confidential witness asserted "that reports were made available to [the CFO], which showed that Well #4 was not producing 7,000 Boe per day," plaintiffs failed to allege that the CFO "actually read the reports or was otherwise made aware of the lower production."[295] This failure was important because, for the CFO "to determine that Well #4's productivity had fallen, he would have had to open not only the email from [the confidential witness'] staff containing the productivity report, but also open the productivity report, parse through data for ATP's other hundred or so wells, find the data for Well #4, and then notice that the data differed

The plaintiff's further argument that "due to their positions, Sterling executives must have known about the unsafe and unsound banking practices," was "entirely speculative." *Id.* at 396. And the firing of two Sterling executives after announcement of the CDO did not support scienter because the complaint alleged no facts to show that the terminations were suspicious as opposed to benign. *Id.*

288. Neiman v. Bulmahn, 854 F.3d 741, 744 (5th Cir. 2017); Firefighters Pension & Relief Fund of New Orleans v. Bulmahn, 147 F. Supp. 3d 493, 502 (E.D. La. 2015) (date of Chapter 11 filing).

289. *Bulmahn*, 854 F.3d at 744–45.

290. *Id.* at 745.

291. *Id.*

292. *Id.* at 744, 750 (as to the CFO's statements on production), 752 (as to the statements about liquidity and the pipeline), 752 (as to the stated reason for the resignation).

293. *Id.* at 745, 747.

294. *Id.* at 747.

295. *Id.* at 748.

from his August statements in a material way."[296] Moreover, the allegations "indicate[d] that [the Chief Operating Officer], not [the CFO], was charged with monitoring production."[297]

While the Fifth Circuit acknowledged decisions identifying special circumstances under which a defendant's position within a company supports an inference that he or she had particular knowledge, no such circumstances were alleged here.[298] With over sixty employees, ATP was not so small that its size would suggest executives would be familiar with day-to-day operational details.[299] Although Well #4 had been projected in August 2011 to produce 22.5 percent of ATP's total output, that percentage was too small to suggest that the well was so critical to company success that the CFO must have been aware of its production.[300] No alleged facts showed that it would have been "readily apparent" to the CFO that his statements about the well were wrong, and no facts suggested that his statements were, when made, inconsistent with those made by others speaking for the company.[301]

Addressing the charge that the defendants misrepresented ATP's liquidity, including its ability to finance the pipeline, the Fifth Circuit noted, first, that "[f]rom 2010 to 2012, ATP's financial statements and the notes that accompanied them repeatedly warned investors that ATP had negative working capital and that ATP was financing its short-term cash or service needs by ceding shares of its long-term profits."[302] And, while the company stated in May 2012 that "'[i]n the event we do not achieve the projected production and cash flow increases [from ATP's planned future projects], we will attempt to fund any short-term liquidity needs through other financing sources,'" it also cautioned "that 'there is no assurance that we will be able to do so in the future if required to meet any short-term liquidity needs.'"[303] Placed in this context, defendants' statements—such as, in May 2012, "indicat[ions] that [ATP] was within its financing capabilities"—were a "disclosed bet on future production," and the revealed risks "undercut[] [the p]laintiffs' scienter allegations," despite the circumstances that ATP retained bankruptcy counsel in June or July 2012 and actually filed its chapter proceeding in August.[304] As to motive for fraud, the cautionary disclosures that the defendants made "severely limited . . . ATP's opportunity to mislead potential capital partners," and the plaintiffs did not allege that any defendant profited personally from the alleged fraud.[305] Finally, "the fact that others disagreed with [d]efendants' assessments of ATP's liquidity"—including the bankruptcy judge who concluded that the company filed its chapter proceeding "too

296. *Id.* at 749.
297. *Id.*
298. *Id.* at 749–50.
299. *Id.*
300. *Id.*
301. *Id.*
302. *Id.* at 750.
303. *Id.*
304. *Id.* at 750–51.
305. *Id.* at 752.

late" and some of the confidential witnesses referenced in the complaint—"does not indicate that [d]efendants' assessments were not truly or reasonably held."[306]

The Fifth Circuit then made short work of the charge that ATP falsely stated on June 7, 2012, that its new CEO hire (announced on June 1) had resigned because "ATP 'was unable to reach a mutually agreeable employment agreement'" with him.[307] The plaintiffs alleged the executive later revealed that he left after quickly discovering the company's disastrous financial condition and unsuccessfully recommending a restructuring to the ATP board.[308] But "[a]bsent some allegation that [the new hire] informed someone at ATP why he resigned, there is no basis for the court to conclude that [the defendants] knew or were reckless in not knowing [his] 'true' reasons."[309]

Significance and analysis. The Fifth Circuit's decision joins a line of cases considering Rule 10b-5 claims against defendants when a company failed to disclose a possible bankruptcy before it occurred.[310] Its message seems sound: a company's financial circumstances may be seen in different ways and, provided that the company has accurately reported its declining financial position, executives do not necessarily commit securities fraud simply because they are more optimistic than others (contemporaneous observers or later critics) that some possible development will save the firm. Differences in judgment do not equal fraud.

The ruling on the CFO's Well #4 comments stretches further. The plaintiffs complained not of an omission but a misrepresentation that the CFO made in person and that provided Boe production information about that particular well,[311] which was projected to provide more than 20 percent of the company's entire production.[312] The holding that, as a matter of law, a complaint did not adequately plead scienter by allegations that the CFO actually received in an email attachment information showing that the production at that well was far below what the officer stated—absent further allegations that the CFO opened the attachment and "parse[d] through data for ATP's other hundred or so wells, [found] the data for Well #4, and then notice[d] that the data differed from his August statements in a material way"[313]—shows how far the special scienter pleading rule can reach to cut off a plaintiff's claim.

But the ruling also reflects the technology of today. It is now easy to distribute data sets to a long list of recipients in an email's "to" line. Whether the Fifth Circuit's judgment in the particular case seems justified at the pleading stage or not, it does remind us not to jump to a conclusion that an individual knew a fact just

306. *Id.*
307. *Id.* at 745–46, 752.
308. *Id.* at 752.
309. *Id.*
310. *See, e.g.*, Beleson v. Schwartz, 419 F. App'x 38, 40 (2d Cir. 2011).
311. *See supra* note 289 and accompanying text.
312. *See supra* note 300 and accompanying text.
313. *See supra* note 296 and accompanying text.

because it resided somewhere deep in an attachment to a message appearing in his or her email "inbox."[314]

Materiality. A fact is material if there is a substantial likelihood that a reasonable investor would consider the fact important in deciding whether to buy or sell the relevant security, because the fact significantly alters the total mix of information available that is relevant to that decision.[315] The First Circuit held in 2017 that a lawyer could properly be convicted of securities fraud for misrepresentations in Rule 144 letters even if the conclusion he reached in those letters—that the securities, after conversion, were freely tradable—was correct based on law other than Rule 144.[316] The Second Circuit found undisclosed pending merger negotiations were not material in a case where a retiree voluntarily left a company, thereby forfeiting his profit interests, on the ground that he knew the employer's business plan was to sell itself.[317]

The defendant in *United States. v. Weed* performed the legal work for a pump-and-dump conspiracy in which private companies would reverse merge into a public shell company, with two of the conspirators holding convertible notes in the post-merger company.[318] Those two would then arrange favorable publicity about the company to push up the price of its stock, and convert their promissory notes, with the help of Weed, who would prepare Rule 144 opinion letters to convince the transfer agent to record the conversion into freely tradable "unrestricted" stock.[319] The two co-conspirators would then sell their stock, whereupon the share price would collapse.[320]

The government prosecuted Weed for securities fraud, wire fraud, and conspiracy to commit securities and wire fraud, with the case "based on his opinion letters falsely stating that the Rule 144 safe harbor applied" so that the stock issued on conversion could be sold at any time.[321] On appeal after a jury convicted him on all counts, Weed contended that Securities Act section 3(a)(9) rendered the converted securities freely tradable and therefore (i) "it was 'legally

314. One other decision provided a noteworthy scienter holding. The case involved the effect of a single patient death on drug sales. *In re* Biogen Inc. Sec. Litig., 857 F.3d 34, 39, 41–46 (1st Cir. 2017) (affirming dismissal in this Rule 10b-5 case). While the complaint referred to information from confidential witnesses, most of them simply said that the drug sales fell in different geographical regions after the death. *Id.* at 42. They did not "quantify the magnitude of the sales decline at the company level," and they were "consistent with the defendants' public disclosures," which repeatedly warned of the risks posed by the death to revenue growth derived from the drug. *Id.* Moreover, the First Circuit found a "significant timing problem" in the scienter allegations as the information from the confidential witnesses concerned developments after the defendants' possibly misleading statements and did not "go to how the defendants' statements . . . were knowingly or recklessly misleading at the time they were made." *Id.* at 42–43.

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

316. *See infra* notes 318–28 and accompanying text.

317. *See infra* notes 329–33 and accompanying text.

318. 873 F.3d 68, 70–71 (1st Cir. 2017), *cert. denied*, No. 17-1430, 2018 WL 1785268 (May 14, 2018).

319. *Id.* at 71.

320. *Id.* at 70–71.

321. *Id.* at 70, 72.

impossible' for him to commit the charged offenses" and (ii) any "misstatements about Rule 144 were immaterial as a matter of law."[322]

Section 3(a)(9) exempts from registration "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."[323] Weed argued to the First Circuit that this provision exempted from registration "not only . . . the initial exchange with the issuer but also . . . all subsequent transactions in the relevant securities."[324] Affirming his conviction,[325] the court held that even if Weed's interpretation was correct, that circumstance would not change the falsity of his representations that Rule 144 applied.[326] Nor would the validity of his position affect the materiality of his falsehoods because, as a practical matter, those falsehoods remained important even if his novel interpretation of section 3(a)(9) was right.[327] As Weed acknowledged, his view of section 3(a)(9) "contradict[ed] over eighty years of securities law," so that a transfer agent or downstream purchaser "might be hesitant to rely on such an untested theory"; indeed, Weed "concede[d] that '[e]ach . . . transfer agent' did, in fact, 'rel[y] on' his Rule 144 representations to issue the requested stock."[328]

Significance and analysis. It may come as a surprise to lawyers that they can be criminally convicted for securities fraud based on false statements in a legal analysis even if their legal conclusion is correct on a different analysis that rests on an innovative interpretation of the securities law.

In one more notable decision on materiality, the Second Circuit affirmed dismissal of a retiree's claim that his employer violated Rule 10b-5 by failing to disclose merger negotiations to him at the time he voluntarily resigned and thereby forfeited profit interests.[329] The court of appeals found that, in context, the allegations were "insufficient to support an inference that the [merger] negotiations were material."[330] The complaint pled that the business plan for the enterprise at which the plaintiff worked "was that it would try to sell itself or its assets soon after developing a market in the pharmaceuticals that it acquired" and that the plaintiff was familiar with that business plan.[331] "Merger discussions and negotiations were thus to be expected."[332] Since the retiree "knew that the venture

322. *Id.* at 72–73.

323. 15 U.S.C. § 77c(a)(9) (2012) (with an exception, not involved here, for securities exchanged in a bankruptcy).

324. *Weed*, 873 F.3d at 73.

325. *Id.* at 70, 75.

326. *Id.* at 73.

327. *Id.* at 73–74.

328. *Id.* at 74 (quoting Weed).

329. Brown v. Cerberus Capital Mgmt., L.P., 703 F. App'x 11, 14–15 (2d Cir. 2017); Brief for Defendants-Appellees at 11, Brown v. Cerberus Capital Mgmt., L.P., 703 F. App'x 11 (2d Cir. 2017) (No. 17-63-cv), 2017 WL 1206580.

330. *Brown*, 703 F. App'x at 14.

331. *Id.*

332. *Id.* The particular discussions the retiree alleged did not lead to a transaction—with the enterprise not receiving "the merger bid that it eventually accepted until some six months after [he] retired." *Id.*

was 'short term' and that [the] executives were interested in quickly selling corporate assets once value could be realized," "[t]he pendency of merger negotiations . . . signaled no more than the . . . enterprise's continued adherence to its announced corporate strategy."[333]

Falsity of Opinions. In 2015, the Supreme Court decided *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*.[334] In the context of the section 11 claim, the Court held that an opinion can be false or misleading in any of three ways.[335] First, it is false if the speaker does not believe the opinion, because an opinion "explicitly affirms one fact: that the speaker actually holds the stated belief," and would therefore "subject the [speaker] to liability (assuming the misrepresentation [is] material)" if it "falsely describe[d the speaker's] state of mind."[336] But liability on this first theory depends on whether the opinion is objectively untrue in the sense that there is no liability if the defendant "think[s] he [is] lying while actually (i.e., accidentally) telling the truth about the matter addressed in his opinion."[337] Second, an opinion is false if it "contain[s] embedded statements of untrue fact."[338] Third, an opinion is misleading if, in stating it, the speaker does not disclose "particular (and material) facts going to the basis for the issuer's opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion . . . misleading to a reasonable person reading the statement fairly and in context."[339]

In 2017, the Ninth Circuit held, in a decision affirming dismissal of a complaint based on opinions, that this same analysis applies in Rule 10b-5 cases.[340] The plaintiff alleged that the defendant entity (Align Technology, Inc., "Align") had purchased another company (Cadent Holdings, Inc., "Cadent") in April 2011 for $187.6 million, allocating $76.9 million of the purchase

333. *Id.* at 15. In one other holding, the Eleventh Circuit found no substantial evidence to support an SEC finding that a representation of compliance with standards for displaying investment performance was material, where the investment firm's newsletter containing that representation later stated, prominently and unequivocally, that the newsletter did not comply with those standards. ZPR Inv. Mgmt., Inc. v. SEC, 861 F.3d 1239, 1251–52 (11th Cir. 2017), *cert. denied*, 138 S. Ct. 756 (2018) (No. 17-874). But such false statements in advertisements without the disclaimer were material. *Id.* at 1249–51.

334. 135 S. Ct. 1318, 1323–24 (2015) (identifying claim as brought under section 11).

335. *Id.* at 1325–31.

336. *Id.* at 1326.

337. *Id.* at 1326 n.2 (citing Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991)).

338. *Id.* at 1327.

339. *Id.* at 1332.

340. City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc., 856 F.3d 605, 616 (9th Cir. 2017) ("Although *Omnicare* concerned Section 11 claims, we conclude that the Supreme Court's reasoning is equally applicable to Section 10(b) and Rule 10b-5 claims."). As set out in the text, the *Align* decision affirmed dismissal both on the ground that the complaint failed to plead falsity and on the ground that it failed to adequately plead scienter. One of the three panel members wrote a concurring opinion in which he agreed with the two other judges on scienter, said that he "might well agree with the majority that the *Omnicare* analysis [as to when an opinion is false or misleading] applies to section 10(b) cases," but concluded that it would be "wiser to leave that arguable and important decision to a case where it has to be made." *Id.* at 624 (Kleinfeld, J., concurring).

price to goodwill value for Cadent operations that provided "computer-aided design and manufacturing" and scanning ("CD/Scan").[341] Align did not write down any of that goodwill until November 2012, when it took a $24.7 million goodwill impairment charge on the CD/Scan business.[342] This was followed by further impairment charges in January and April 2013, resulting in a reduction of that goodwill to zero.[343] Suing Align and its CEO and CFO under Rule 10b-5,[344] the plaintiff alleged that statements made in press releases, 10-Qs, and a 10-K over the period January 30, 2012, to October 17, 2012, were false or misleading because they included asset values based on the full $76.9 million of goodwill, and included fraudulent statements such as that the company "determined that no impairment needed to be recorded as the fair value of the reporting units [was] significantly in excess of the carrying value" and "performed impairment testing 'whenever events or changes in circumstances indicate[d] that the carrying value of such assets may not be recoverable.'"[345]

Understanding "statements regarding goodwill valuations" to be "opinion statements" and holding that a determination that no goodwill impairment need be recorded is also an opinion because it "expresses [d]efendants' qualitative assessment of the [CD/Scan] division's fair value,"[346] the Ninth Circuit examined the complaint to determine whether it pled that the statements were false or misleading in the ways that *Omnicare* identified.[347] Turning to the first way enunciated in *Omnicare*, the Ninth Circuit found no *direct* allegations that the defendants "believed that [CD/Scan's] goodwill was impaired at the end of 2011 or during the first and second quarters of 2012, . . . did not believe that [the issuer] performed impairment testing when required, and . . . did not believe that [CD/Scan's] fair value was 'significantly in excess of the carrying value.'"[348]

Neither did the complaint contain any allegations from which the court could *infer* that the defendants did not believe the challenged numbers and statements.[349] While the plaintiff alleged that the defendants knew, when Align

341. *Id.* at 610. Goodwill comprises the amount paid in excess of fair value of assets. *Id.*

342. *Id.* at 611–12.

343. *Id.* at 612.

344. *Id.* at 609, 612.

345. *Id.* at 612–13.

346. *Id.* at 609 (defining class period), 613–14.

347. *Id.* at 616–18.

The *Align* opinion reviewed previous Ninth Circuit decisions addressing the falsity of opinions and found them generally in accord with the first way in which an opinion might be false under *Omnicare*'s analysis—that an opinion is false if the speaker or author does not believe it at the time he or she speaks or writes the opinion. *Id.* at 614–15. In this regard, the Ninth Circuit read the Supreme Court opinion as requiring—for this first alternative—that the plaintiff plead "both objective and subjective falsity." *Id.* The court of appeals recognized that the third way that *Omnicare* found an opinion might be actionable was new. *Id.* at 615–16. And the Ninth Circuit held that previous circuit authority—holding that an opinion is false simply if "there is no reasonable basis for the belief," *id.* at 616 (internal quotations omitted)—was "irreconcilable" with *Omnicare*, which provides a more nuanced approach in its third alternative. *Id.*

348. *Id.* at 616–17.

349. *Id.* at 617.

bought Cadent, that Cadent had inflated its 2010 revenues by unsustainable discounts, the plaintiff did not allege that Align had used the supposedly inflated 2010 revenues in analyzing the CD/Scan goodwill during the period of the alleged fraud.[350] Although the plaintiff alleged that defendants knew that Align was experiencing problems integrating the CD/Scan operations after the acquisition (in part because Align moved the operations from New Jersey to Mexico and Costa Rica, necessitating the firing of experienced employees, and the hiring of new ones, with a consequent decline in customer service), knew of competitive pressures, and knew that its relationship with a European distributor was deteriorating,[351] the impairment analysis could have taken into account "positive and mitigating events" such as CD/Scan revenue increases in sequential quarters (even though not at hoped-for levels) and an increase in international sales in the first quarter of 2012 after a decline in the last two quarters of 2011.[352] And the complaint pled no particular competitive developments that actually matured during the period of the alleged fraud.[353]

Leaving aside the one statement to which the Ninth Circuit found the second *Omnicare* alternative to apply[354] and moving to the third way in which opinions might be actionable—because they mislead by omitting either facts that cut against the opinion or concerning the inquiry on which the opinion is based—the plaintiff alleged omission of three material facts.[355] First, the goodwill opinions assertedly misled by failing to disclose that Cadent had pumped its 2010 sales by large discounts.[356] But, the Ninth Circuit responded, a predicate to this omission's importance was that the defendants used the 2010 sales "to conduct [their] goodwill impairment testing at the end of 2011," and the plaintiff did not allege that essential predicate.[357] Second, the complaint charged that the defendants' statements about goodwill misled by failing to disclose the integration and competitive problems that were plaguing CD/Scan.[358] The court of appeals answered that the defendants did indeed disclose both—by, as examples, a 10-Q filed on May 5,

350. *Id.*
351. *Id.* at 611.
352. *Id.* at 618.
353. *Id.*
354. The court found that the second way in which *Omnicare* found an opinion might be false—because the statement of the opinion includes an embedded false fact—might apply to only one of the challenged statements. *Id.* at 614. That statement said: "[D]uring the fiscal year ended December 31, 2011, there were no facts and circumstances that indicated that the fair value of the reporting units may be less than their current carrying amount." *Id.* at 613. The court of appeals held that the "reference to 'no facts or circumstances' asserts an objectively verifiable fact by identifying an aspect of [d]efendants' goodwill methodology as opposed to a qualitative aspect of the valuation itself. Accordingly, . . . [the statement just quoted] should be considered an opinion statement with an embedded statement of fact." *Id.* at 614. But because the complaint did not allege "the assumptions underlying [d]efendants' goodwill valuations of [CD/Scan]," they could not "demonstrate that [d]efendants were aware of additional 'facts and circumstances' that would have indicated that 'the fair value of the [CD/Scan] division [might] be less than [its] carrying amount." *Id.* at 619.
355. *Id.* at 618.
356. *Id.*
357. *Id.* at 618–19.
358. *Id.* at 618.

2011 warning "that 'the anticipated financial [and] strategic benefits' of acquiring Cadent might be impeded by potential risks which included 'aggressive competition from other manufacturers of intraoral scanners' which could result in 'price reductions and loss of sales'" and the Align CEO's statement during an April 2012 investor call "that 'in the course of creating a more integrated business we have negatively impacted several important customer-facing functions like customer service, tech support, and even delivery schedules in some cases.'"[359] Third, the plaintiff contended that the statements about goodwill misled by failing to include the fact that the defendants failed to test for goodwill impairment at the end of 2011.[360] The court of appeals rejected this argument because its significance rested on "[p]laintiff's *conclusion* based on its belief that no set of reasonable assumptions could support Defendants' determination in the fourth quarter of 2011 that the [CD/Scan] goodwill was unimpaired."[361]

On much the same reasoning, the Ninth Circuit concluded that the complaint failed to plead facts raising a strong inference of scienter.[362] Observing that "a company need only conduct interim goodwill impairment testing if it concludes, after assessing 'the totality of events' as well as any 'positive and mitigating events,' that negative events or circumstances 'would more likely than not' cause impairment," and that therefore, "a corporation must exercise its judgment in assessing both positive and negative factors when determining whether interim goodwill impairment testing is necessary," the court of appeals reasoned that "[i]t therefore follows that a corporation's mere knowledge of negative factors that potentially indicate goodwill impairment does not of itself support an inference that a corporation acted with scienter in exercising its judgment to conclude that no goodwill impairment is likely to occur."[363] Here, the complaint's "fail[ure] to allege the precise assumptions that [d]efendants used in conducting the 2011 year end goodwill valuation of the [CD/Scan] . . . and in determining that no interim goodwill valuation analysis was needed in the first and second quarters of 2012," left it impossible to understand the full set of considerations that went into the company's decisions and how it weighted the negative factors that the plaintiff identified against mitigating and positive factors.[364]

359. *Id.* at 619.
360. *Id.* at 618.
361. *Id.* at 619.
362. *Id.* at 619–23.
363. *Id.* at 621 (citations omitted).
364. *Id.* The court also noted the complaint's failure to plead that the individual CEO and CFO defendants knew about Cadent's revenue-boosting discounts in 2010. *Id.* For example, the plaintiff did not allege that either of these defendants visited the "data room" in which Cadent permitted Align personnel to examine Cadent documents before the acquisition. *Id.* at 610, 620. And the pre-acquisition operations of Cadent were not "core operations" at *Align* of which the *Align* CEO and CFO must have known. *Id.* at 620.

Looking at the other facts offered in support of scienter, the Ninth Circuit was unimpressed by the CEO's stock sales in February 2012 because they were at a price ($25.51 and $26.26) below both the high price during the class period ($39.17) and the price at the close of the last day of the class period ($28.18), on which the issuer announced the first significant impairment charge. *Id.* at 622. As to the CFO's resignation on the date that Align announced the second impairment charge, "the fact that [he]

Significance and analysis. The conclusion that *Omnicare*'s analysis of opinion falsity should apply in Rule 10b-5 cases is sound. The Supreme Court based its analysis on the language of section 11, which imposes liability when a registration statement "either 'contain[s] an untrue statement of a material fact' or 'omit[s] to state a material fact . . . necessary to make the statements therein not misleading.'"[365] Rule 10b-5(b) similarly imposes liability for either "mak[ing] any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[366] The three ways in which the Court found, in *Omnicare*, that opinions can be false or misleading derive just as comfortably from the language in Rule 10b-5(b) as from the language in section 11, including the third way identified by the Supreme Court—i.e., that an opinion might mislead, in context, if offered without related facts that might throw the opinion into question.[367]

Forward-looking Statements. The Exchange Act includes protections for "forward-looking statements," that are defined to include "a projection of revenues, income (including income loss), earnings (including earnings loss) per share," and "a statement of future economic performance."[368] The Act provides two safe harbor protections for such statements in suits by private plaintiffs.[369] First, a plaintiff cannot recover on the ground that such a statement is false or misleading unless the plaintiff can prove that the defendant, if an individual, made the statement "with actual knowledge . . . that [it] was false or misleading," or, if a "business entity," made the statement "by or with the approval of an executive officer of that entity" who, at the time, had "actual knowledge . . . that [it] was false or misleading."[370] Second, the plaintiff cannot recover at all if the statement was "identified as a forward-looking statement, and [was] accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the . . . statement."[371]

The Ninth Circuit provided an interesting opinion last year in a case in which the defendants mixed forward-looking statements with statements that were not forward-looking.[372] The Third Circuit authored a decision holding a warning that loss of a distributor could lead to adverse financial *effects* was not false,

remained an employee of Align for an additional six months after the first goodwill impairment announcement was made . . . diminishes any inference of scienter based on his resignation." *Id.*

365. Omnicare Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1323 (2015) (quoting 15 U.S.C. § 77k(a)).

366. 17 C.F.R. § 240.10b-5(b) (2017).

367. As the Ninth Circuit pointed out, the Second Circuit has also applied *Omnicare* in a Rule 10b-5 case. *Align*, 856 F.3d at 606 (citing Tongue v. Sanofi, 816 F.3d 199, 209–10 (2d Cir. 2016)).

368. 15 U.S.C. § 78u-5(i)(1)(A) & (C) (2012). The Securities Act contains a similar provision. *Id.* § 77z-2(i)(1)(A) & (C).

369. *Id.* § 78u-5(c)(1) (setting out protections that apply "in any private action arising under this [Act] that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading").

370. *Id.* § 78u-5(c)(1)(B).

371. *Id.* § 78u-5(c)(1)(A).

372. *See infra* notes 374–92 and accompanying text.

even if the defendants had already decided to terminate the distributor, because the warning concerned the *effects* of losing the distributor (which effects had not matured when the issuer provided the warning) rather than the risk that the relationship with the distributor would end.[373]

In the Ninth Circuit case, investors alleged that the defendant company—which developed and sold software to record and manage electronic health and dental information—and its officers violated Rule 10b-5 by "ma[king] false or misleading statements about the current and past state of [the company's] sales 'pipeline,' and us[ing] those statements to support public guidance to investors about [the company's] projected growth and revenue."[374] For example, in a May 17, 2012 conference call, the CEO repeated a prediction that the earnings per share would increase 20% to 25% in fiscal 2013 and said: "We are confident in our ability to deliver on this guidance. . . . Supporting our confidence in this guidance range are a number of factors, including our current sales pipeline[.]"[375] The defendants also said that a large proportion of projected sales growth would consist of "greenfield" sales—i.e., sales to healthcare providers making their initial foray into electronic recordkeeping.[376] For example, the CFO told attendees at an investment conference in June 2011 "that the market for [the company's] products in ambulatory health care facilities was 'greenfield for the most part' and that he thought 'it's going to be that way for a while.'"[377] The CEO said in an October 2011 analyst conference call "that 'the greenfield opportunities are plentiful'" and that "'more than 75% of the midsize practice market is still fair game for new system sales.'"[378] He projected in that call "a 'revenue range of growth of 21% to 24% for the year and an EPS [earnings per share] growth of 29% to 33% for the year.'"[379]

Reversing the district court's dismissal of the case, which rested on the conclusions that the defendants' non-forward-looking statements were puffery and their forward-looking statements were protected by the Exchange Act,[380] the Ninth Circuit observed that the "First, Second, Third, Fifth, and Seventh Circuits have all concluded that where defendants make mixed statements containing non-forward-looking statements as well as forward-looking statements, the non-forward-looking statements are not protected by the safe harbor."[381] Here, the plaintiffs alleged that "[o]n eight separate occasions, [company] officers knowingly

373. *See infra* notes 393–418 and accompanying text, particularly at notes 408–12.

374. *In re* Quality Sys., Inc. Sec. Litig., 865 F.3d 1130, 1135, 1140 (9th Cir. 2017), *petition for cert. filed*, No. 17-1056 (U.S. Jan 26, 2018).

375. *Id.* at 1137–38.

376. *Id.* at 1136.

377. *Id.*

378. *Id.*

379. *Id.*

380. *Id.* at 1135, 1150.

381. *Id.* at 1141–42 (citing *In re* Stone & Webster, Inc., Sec. Litig., 414 F.3d 187, 211–13 (1st Cir. 2005); *In re* Vivendi, S.A., Sec. Litig., 838 F.3d 223, 246 (2d Cir. 2016); Institutional Inv'rs Grp. v. Avaya, Inc., 564 F.3d 242, 255 (3d Cir. 2009); Spitzberg v. Houston Am. Energy Corp., 758 F.3d 676, 691–92 (5th Cir. 2014); Makor Issues & Rights, Ltd. v. Tellabs Inc. (Tellabs II), 513 F.3d 702, 705 (7th Cir. 2008)).

made materially false or misleading non-forward-looking statements about the state of [the company's] sales pipeline."[382] Those statements were not puffery, the Ninth Circuit held, because the officers "did not just describe the pipeline in subjective or emotive terms," but "provided a concrete description of the past and present state of the pipeline" that "repeatedly reassured investors during the class period that the number and type of prospective sales in the pipeline was unchanged, or even growing, compared to previous quarters."[383] The plaintiffs adequately pled that the non-forward-looking statements were false and misleading by, among other things, alleging that the market for new systems was saturated and drying up.[384] The complaint also adequately pled scienter respecting those statements, which (because they were not forward-looking) were not subject to the "actual knowledge" requirement in the safe harbor but could support a Rule 10b-5 action if made with the "deliberate recklessness" that suffices for scienter in the Ninth Circuit.[385]

The court of appeals then turned to the forward-looking statements and divided them into two categories—(i) those joined with non-forward-looking statements that were false or misleading and (ii) those that were not. As to the first (statements that combined forward-looking language with false information that was not forward-looking), the Ninth Circuit held that neither of the two statutory safe harbor protections shielded those statements from liability.[386] The complaint adequately pled that the defendants had "actual knowledge" that these statements were false or misleading.[387] While some of the forward-looking statements in this first category were accompanied by cautionary language,[388] that language was necessarily insufficient because "virtually no cautionary language short of an outright admission that the non-forward-looking statements were materially false or misleading would have been adequate . . . [and n]o such cautionary language was provided."[389] Turning to the second category—what the court called "free-standing forward-looking statements"—the Ninth Circuit found these statements *were* protected by "cautionary language . . . sufficiently meaningful to qualify for safe harbor."[390]

382. *Id.* at 1142–43.

383. *Id.* at 1144.

384. *Id.* Plaintiffs alleged fraud during a class period stretching from May 26, 2011, to July 25, 2012. *Id.* at 1135. The complaint recounted information from confidential witnesses who reported internal company communications suggesting that the individual defendants knew their statements were false, including that the CEO "personally explained on conference calls as early as April 2011 that the market had become saturated after a 'bubble' and that [the company] would be forced to switch from greenfield sales to replacement systems." *Id.* at 1144.

385. *Id.* at 1144. And the CEO had sold 87% of his company stock in February 2012, for proceeds totaling more than seven times his salary—which reinforced the scienter inference as to him because this "massive and uncharacteristic sale in February, made near the apogee of [the company's] stock price during the Class Period, and shortly before the stock went into a steep decline (bottoming out on July 26, 2012) is, to say the least, 'suspicious.'" *Id.* at 1146 (referring to the Ninth Circuit's view that stock sales that are unusual or suspicious can support a scienter inference).

386. *Id.* at 1146–48.

387. *Id.* at 1149 (referring to allegations summarized earlier in the opinion, presumably including those recounted in *supra* notes 384 and 385).

388. *Id.* at 1147–48.

389. *Id.* at 1148.

390. *Id.* at 1149.

Significance and analysis. Courts of appeals decisions to date hold that the two statutory safe harbor protections are independent and, accordingly, a forward-looking statement cannot support a private Rule 10b-5 action if it is accompanied by sufficient cautionary language—even if the plaintiff pleads facts raising a strong inference that the defendant made the statement with "actual knowledge" that it was false or misleading.[391] The Ninth Circuit's treatment of the "free-standing" forward-looking statements—the ones not joined with false or misleading statements of current facts (particularly the size and composition of the company's sales pipeline)—accords with this emerging consensus. But the Ninth Circuit trod a new path by holding that forward-looking statements joined with false statements of current fact offered for the purpose of supporting the forward-looking statements were actionable because (i) the defendants' knowledge that their statements of current fact were false supplied the "actual knowledge" that the forward-looking statements were also false or misleading and (ii) the cautionary statements accompanying the forward-looking statements were by law insufficient for failing to warn that the supposedly supportive current facts were false.

This prompts four observations. First, companies under this set of rules are better off making an unadorned projection rather than making a projection and justifying it with any accompanying current facts. Second, the Ninth Circuit reasoning undercuts the emerging consensus that the unadorned projection—even if knowingly false or misleading—should always enjoy safe harbor protection simply because cautionary language accompanies it. Where even an unadorned projection is based on information the defendant knows to be false, no cautionary language can, by the Ninth Circuit's logic, be sufficient unless it says that the defendant is using false information to generate that projection.

Third, the Ninth Circuit's decision fits comfortably into the second way in which opinions may be false under the Supreme Court's *Omnicare* analysis (i.e., that the opinion includes an embedded false fact),[392] but adds the analytical note that the embedded fact can be analyzed separately from the opinion and, where the opinion is a prediction and the embedded fact is false and included to support the prediction, the falsity of the embedded fact can prevent invocation of the statutory protection derived from accompanying the prediction with cautionary language. Oddly, the Ninth Circuit does not mention *Omnicare*.

Fourth, an alternative analysis might disaggregate a forward-looking statement from a statement of current fact joined to it. One problem with that path, from a plaintiff's perspective, is that, if the forward-looking statement is protected and thereby not actionable, proof of loss causation and damages may be difficult because it may be hard to separate out the effect on stock price of the false and actionable statement of current fact from the effect of the protected forward-looking statement.

391. *See* OFI Asset Mgmt. v. Cooper Tire & Rubber Co., 834 F.3d 481, 502–03 (3d Cir. 2016); Slayton v. Am. Express Co., 604 F.3d 758, 766 (2d Cir. 2010); *In re* Cutera Sec. Litig., 610 F.3d 1103, 1112 (9th Cir. 2010).

392. *See supra* note 338 and accompanying text.

Precisely in order to access the second statutory protection for them, issuers frequently accompany forward-looking statements with cautionary language warning of risks that might frustrate realization of the future that the statements foretell.[393] Plaintiffs in *Williams v. Globus Medical, Inc*. brought a Rule 10b-5 action against the company and executives based on risk disclosures and revenue/income projections.[394] Globus designed, produced, and sold musculoskeletal implants.[395] It sold the devices both through its own representatives and independent distributors.[396] The contract for a distributor in Louisiana and Mississippi expired on December 31, 2013.[397] Plaintiffs alleged that Globus decided, at about that time, that it would end its relationship with the distributor and substitute its in-house sales personnel for that territory.[398] Globus nevertheless extended the distributor's contract through April 2014—with the relationship ultimately ending shortly after the middle of that month when the distributor rejected a proposal that would have absorbed the distributor's business (and sales representatives) into Globus.[399]

As Globus's discussions with the distributor went forward, and as Globus sought to substitute its personnel for the distributor's sales force after Globus and the distributor parted ways, Globus made periodic SEC filings and its executives provided revenue and net income guidance.[400] On February 26, 2014, the CFO projected full-year revenue at $480 to $486 million and eps at 90¢–92¢.[401] On March 14, Globus filed a 10-K that included as one of the company's risks that "we may not be able to generate anticipated sales . . . [i]f we are unable to maintain and expand our network of direct sales representatives and independent distributors," with the company adding that "[i]f any of our direct sales representatives were to leave us, or if any of our independent distributors were to cease to do business with us, our sales could be adversely affected" and further that "if any such independent distributor were to cease to distribute our products, our sales could be adversely affected."[402]

On April 29, about ten days after Globus parted with the southern distributor, the CFO repeated the projections of $480–$486 million in full year sales and 90¢–92¢ eps.[403] The next day, Globus filed a 10-Q which stated that the risks to its business had not changed from those identified in the March 10-K.[404] However, on August 5, Globus issued a press release lowering revenue projections to $460–

393. See *supra* note 371 and accompanying text.
394. 869 F.3d 235, 237–40 (3d Cir. 2017).
395. *Id*. at 238.
396. *Id*.
397. *Id*.
398. *Id*.
399. *Id*. at 238–39. On April 18, 2014, Globus offered to pay the distributor a royalty if the distributor's employees became Globus employees and the distributor turned over its customers to Globus. *Id*. The distributor declined those terms. *Id*. at 239.
400. *Id*. at 238–39.
401. *Id*. at 238.
402. *Id*.
403. *Id*. at 239.
404. *Id*.

$465 million, with the estimated eps unchanged.[405] The COO stated in a conference call later that day that the decision against "renew[ing] our existing contract with a significant U.S. distributor . . . negatively impact[ed] our sales."[406] The company's stock price dropped by 17.9 percent the next day.[407]

Affirming the district court's dismissal,[408] the Third Circuit rejected both parts of the plaintiffs' case.[409] First, the plaintiffs argued that Globus's risk disclosures in the March 10-K and the April 10-Q were misleading because they warned of the possibility of losing an independent distributor when, in fact, the company had already determined—by the time it filed the 10-K—that it would substitute in-house sales representatives for the distributor and—by the time it filed the 10-Q—had ended the relationship with the distributor.[410] Plaintiffs invoked the principle that warning of a risk that might mature can mislead if the risk has, in fact, already matured.[411] The court of appeals, however, found that "[t]he risk actually warned of [was] the risk of adverse effects on sales—not simply the loss of independent distributors generally," and that the plaintiffs had "not [pled] that Globus's sales were adversely affected by the decision to terminate [the distributor] at the time the risk disclosures were made" in either the 10-K or the 10-Q.[412]

The second part of the plaintiffs' case "hinge[d] on their conclusory assertion that Globus's 'announced forecast incorporated [the distributor's] projected sales figures for the remainder of the 2014 fiscal year.'"[413] Ruling that the plaintiffs had failed to plead that the projections were false or misleading for this reason, the Third Circuit found that this conclusion rested on "conjecture" rather than pled facts such as "contemporaneous sources to show Globus knowingly incorporated . . . revenue [generated by the distributor] into those projections."[414] More particularly, the plaintiffs failed to plead sufficiently "that, at the time the projections were made, Globus failed to adequately account for the imminent change in distributorship and any resulting effect on sales."[415] Moreover, since the projections were forward-looking statements, the plaintiffs had to allege "actual knowledge of falsity on the part of Globus and its executives."[416] While the pled facts created a "plausible . . . infer[ence] that Globus knew or should have known that ending its relationship with [the distributor] could have some effect on its sales," none of them "support[ed] the[] claim that Globus incorporated anticipated revenue from [the distributor] in its projections."[417] To the contrary,

405. *Id.*
406. *Id.*
407. *Id.*
408. *Id.* at 238, 246.
409. *Id.* at 241–46.
410. *Id.* at 238–39, 241.
411. *Id.* at 241–42.
412. *Id.* at 242.
413. *Id.* at 244.
414. *Id.*
415. *Id.* at 245.
416. *Id.*; *see also* 15 U.S.C. § 78u-5(i)(1)(A) (2012).
417. *Globus*, 869 F.3d at 246.

"given plaintiffs' allegations regarding Globus's extensive, months-long planning for the end of its relationship with [the distributor]—including the company's broad strategy to transition its sales force from independent distributors to in-house sales representatives and the fact that a new in-house sales representative was in place to take over [the distributor's] geographic territory before the relationship was terminated—the more plausible inference . . . is that Globus accounted for the change in strategy when it devised its sales projections for the year."[418]

Significance and analysis. One question is whether *Omnicare* supersedes the Third Circuit analysis. Instead of analyzing whether Globus's projections were false or misleading because they included projected sales by the distributor being terminated, an *Omnicare* analysis might ask whether failing to disclose that the distributor's anticipated sales were included rendered the projections misleading.[419] Rephrasing the analysis this way would not affect the outcome in the Third Circuit decision because the complaint would still have had to plead facts to show that the projections did include those sales. But the manner in which the claim was phrased would have changed.

Proper Defendant in a Rule 10b-5 Case Based on Misrepresentations. Rule 10b-5 includes three subparts, each of which prohibits actions "in connection with the purchase or sale of any security."[420] Subpart (b) forbids "mak[ing] any untrue statement of a material fact or . . . omit[ing] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[421] Subpart (a) forbids "employ[ing] any device, scheme, or artifice to defraud," and subpart (c) forbids "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[422]

In *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court interpreted subpart (b) to apply to "makers" of false or misleading statements, defined the "maker" of a statement to be "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it," and added that "in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed."[423] Employing this rule, the Court held that an investment adviser did not "make" the statements in prospectuses filed by the Massachusetts business trust that organized the mutual funds whose shares the prospectuses sold.[424] This left open the relationship between subparts (a) and (c), on the one hand, and subpart (b), on the other; and, in particular, whether an actor—in a Rule 10b-5 case based on misrepresentations—can

418. *Id.*
419. *See supra* note 339 and accompanying text.
420. 17 C.F.R. § 240.10b-5 (2017).
421. *Id.* § 240.10b-5(b).
422. *Id.* § 240.10b-5(a), (c).
423. 564 U.S. 135, 142–43 (2011).
424. *Id.* at 146–47.

violate (a) or (c) even if that actor is not a "maker" of the misrepresentations and therefore cannot violate (b).

The SEC took up that very question and blurred *Janus* considerably. Thus, the Supreme Court specifically wrote in *Janus* that an actor who drafted a statement would not "make" the statement for Rule 10b-5(b) purposes if another actor had ultimate authority over content and dissemination.[425] In deciding the subsequent *Flannery* administrative enforcement proceeding, however, the Commission wrote that "primary liability under Rule 10b-5(a) and (c) . . . encompasses the 'making' of a fraudulent misstatement to investors, *as well as the drafting or devising of such a misstatement*."[426]

The D.C. Circuit addressed this (a)/(c) versus (b) distinction last year in *Lorenzo v. SEC*.[427] The petitioner was the director of investment banking at a broker-dealer.[428] At a time when his only investment banking client (the "issuer") was selling convertible debentures, the defendant sent emails to two potential investors that, among other things, said that the issuer "has over $10 mm in confirmed assets."[429] This was false because the issuer had filed both an 8-K and a 10-Q about two weeks before the emails, with the 8-K reporting the issuer's determination that its intellectual property (its previously reported most valuable asset) was of "no value" and the 10-K reporting that the issuer's assets totaled $660,408.[430] Critically, and although the petitioner "signed both messages with his name and title as 'Vice President—Investment Banking,'" "[o]ne of [the] messages said it had been sent '[a]t the request of Gregg Lorenzo,' . . . and the other stated it had been sent '[a]t the request of Adam Spero [a broker with [the broker-dealer]] and Gregg Lorenzo.'"[431] Gregg Lorenzo was the defendant's "boss," and "[v]oluminous testimony established that [the petitioner, in his emails,] transmitted statements devised by Gregg Lorenzo at Gregg Lorenzo's direction."[432]

The SEC brought an administrative enforcement proceeding against the petitioner.[433] First an ALJ and then, on review, the Commission found that the pe-

425. *Id.* at 143.

426. John P. Flannery & James D. Hopkins, Securities Act Release No. 9689, Exchange Act Release No. 73,840, Investment Company Act Release No. 31,374, 2014 WL 7145625, at *12 (Dec. 15, 2014) (emphasis added), *vacated on unrelated grounds by* Flannery v. SEC, 810 F.3d 1 (1st Cir. 2015) (misrepresentations were not material).

427. 872 F.3d 578 (D.C. Cir. 2017), *petition for cert. filed*, No. 17-1077 (U.S. Jan. 31, 2018).

428. *Id.* at 581.

429. *Id.*

430. *Id.* The emails included two other false statements: (i) that the issuer had "'purchase orders and [letters of intent] for over $43 mm in orders,'" *id.* (quoting emails), even though at the time the issuer "had no outstanding purchase orders," *id.* at 585, and the petitioner thought that a $43 million letter of intent would never "'turn into purchases,'" *id.* (quoting the petitioner); and (ii) that the broker-dealer had "'agreed to raise additional monies to repay [securities] holders (if necessary),'" *id.* at 581, even though the petitioner, at the time, "did not believe [the broker-dealer] could raise enough money" for such a repayment, *id.* at 586.

431. *Id.* at 581–82 (quotations from the emails) (citations to the record omitted).

432. *Id.* at 587.

433. *Id.* at 582. The Commission's staff also named Gregg Lorenzo and the broker-dealer firm as respondents. *Id.* They settled. *Id.* The respondent before the Commission and the petitioner in the court of appeals was Francis Lorenzo. He was not related to Gregg Lorenzo. *Id.* at 581.

titioner had violated Rule 10b-5 and Securities Act section 17(a)(1), and imposed sanctions including a lifetime bar from the securities industry.[434] On petition to the D.C. Circuit, the court of appeals found that the petitioner did not violate Rule 10b-5(b) because he was not the "maker" of the false statements in his emails.[435] He did not have "ultimate authority over what [the emails] said and whether it was said."[436] Instead, he simply cut and pasted the content, as directed by Gregg Lorenzo, the petitioner's "boss."[437] While the petitioner "played an active role in perpetrating the fraud by producing the emails containing the false statements and sending them from his account in his capacity as director of investment banking (and doing so with scienter)," he did not satisfy the *Janus* test for a maker.[438] While he sent the emails out under his own signature, "[t]hat sort of signature line . . . can often exist when one person sends an email that 'publishes a statement on behalf of another,' with the latter person retaining 'ultimate authority over the statement.'"[439] He therefore was not liable under Rule 10b-5(b).[440]

But, relying in part on its *Flannery* order, the Commission had also concluded that, independently of whether the petitioner violated Rule 10b-5(*b*), he had—by sending the emails—violated both Section 17(a)(1) and Rule 10b-5(*a*) and (*c*) and the D.C. Circuit "sustain[ed] the Commission's conclusion to that effect."[441] The ruling on section 17(a)(1) was unremarkable because section 17(a)(1) does not contain the word "make," and other courts have held that *Janus* does not affect the application of that statute.[442] However, the holding that the petitioner was liable under Rule10b-5(a) and (c) raised the question of whether, in the words of the dissenting judge, the SEC was trying "to end-run the Supreme Court."[443] The majority in this two-to-one decision found "no blanket reason . . . to treat the various provisions [of Rule 10b-5] as occupying mutually exclusive territory, such that false-statement cases must reside exclusively within the province of Rule 10b-5(*b*)."[444] The majority agreed with the Commission that cutting and pasting his boss's words into an email of his own with scienter—either an intent to defraud or extreme

434. *Id.* at 582, 586.

435. *Id.* at 586–88.

436. *Id.* at 587.

437. *Id.* The court added that "[t]he emails . . . began by stating that they were being sent at Gregg Lorenzo's request." *Id.* at 588.

438. *Id.*

439. *Id.* (quoting Janus Capital Grp, Inc. v. First Derivative Traders, 564 U.S. 135, 142 (2011)).

440. *Id.*

441. *Id.*

442. 15 U.S.C. § 77q(a)(1) (2012); SEC v. Big Apple Consulting USA, Inc., 783 F.3d 786, 796 (11th Cir. 2015) (holding that section 17(a)(1) liability is not affected by *Janus*, and collecting cases to that effect).

443. *Lorenzo*, 872 F.3d at 601 (Kavanaugh, J., dissenting).

444. *Id.* at 591 (emphasis added) (elaborating: "any suggestion that the coverage of Rule 10b-5(b) must be distinct from that of Rules 10b-5(a) and (c) presumably would mean that each of the latter two provisions likewise must occupy entirely separate ground from one another. In our view, however, the provisions' coverage may overlap in certain respects.").

recklessness—"'constituted employing a deceptive "device," "act," or "artifice to defraud" for purposes of liability under Section 10(b), Rule 10b-5(a) and (c).'"[445]

To the petitioner's argument that holding him liable for a Rule 10b-5(a) and (c) violation would render *Janus* "meaningless," the D.C. Circuit responded that (i) *Janus* was concerned with maintaining the distinction between primary liability and aiding and abetting; (ii) the role of the investment adviser found not to have "made" the statements in the mutual fund prospectuses in *Janus* "was unknown to the investors who ultimately received them"; and (iii) in contrast, the petitioner "effectively vouched for the emails' contents and put his reputation on the line by listing his personal phone number and inviting the recipients to 'call with any questions.'"[446] The majority acknowledged that other courts of appeals have held that "'scheme liability'—i.e., the conduct prohibited by Rule[] 10b-5(a) and (c)—requires something more than false or misleading statements,"[447] but stated that it "read the provisions differently."[448]

The court of appeals then granted the petition in part, vacated the sanctions, and remanded the matter to the SEC—in particular to consider whether the circumstance that the petitioner did not "make" the statements in the emails and so could not be liable under Rule 10b-5(*b*), but was liable under Rule 10b-5(*a*) and (*c*), as well as under section 17(a)(1)—affected the sanctions that the Commission imposed.[449]

Significance and analysis. The D.C. Circuit decision, oddly, reached out to address the (a)/(c) versus (b) issue. The SEC contended on appeal that, at a minimum, the petitioner's "signature on the emails specifically attributes the statements to him," and that "attribution is itself sufficient to find that [petitioner] was the maker under *Janus*," and therefore had violated Rule 10b-5(*b*).[450] That reasoning accords with decisions holding that signing a document attributes the statements in it to the signer.[451] Even though *Janus* states that, "in the ordinary case," a statement that is attributed is made "only by . . . the party to whom it is attributed,"[452] the emails here—where the petitioner sent on a statement that he said was originated by another—might have been attributed to both.[453]

445. *Id*. at 589 (quoting Francis V. Lorenzo, SEC Release No. 9762, 111 SEC Docket 1761, 2015 WL 1927763, at *11 (Apr. 29, 2015)).

446. *Id*. at 590 (quoting the emails).

447. *Id*. at 594.

448. *Id*. at 595.

449. *Id*. The dissenting judge saw the case as part of a concerted effort by the SEC to frustrate limitations on primary liability. *Id*. at 601 (Kavanaugh, J., dissenting) (footnote omitted).

450. Brief of the Securities and Exchange Commission, Respondent at 30, Lorenzo v. SEC, 873 F.3d 578 (D.C. Cir. 2017) (No. 15-1202), 2015 WL 9413112, at *30. Indeed, at one point the D.C. Circuit seems to characterize the emails as "self-attributed." *Lorenzo*, 872 F.3d at 591.

451. *See* SEC v. Brown, 878 F. Supp. 2d 109, 116 (D.C. Cir. 2012); Thomas v. Magnachip Semiconductor Corp., 167 F. Supp. 3d 1029, 1046–48 (N.D. Cal. 2016); Special Situations Fund III QP. L.P. v. Brar, No. 14-cv-04717-SC, 2015 WL 1393539 (N.D. Cal. Mar. 26, 2015); *In re* Smith Barney Transfer Agent Litig., 884 F. Supp. 2d 152, 163–64 (S.D.N.Y. 2012).

452. Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 142–43 (2011).

453. A statement can be "made" by more than one person within the meaning of *Janus*. *See* Glickenhaus & Co. v. Household Int'l, Inc., 787 F.3d 408, 427 (7th Cir. 2015) ("Nothing in *Janus* precludes a single statement from having multiple makers.").

As it stands, it is difficult to know exactly the extent to which the D.C. Circuit opinion endorses the Commission's decision in *Flannery*.[454] The court of appeals did seem to cabin its holding to cases in which the defendant actually identifies himself or herself in the communication that is authored by another and then passed on by the defendant, as the court distinguishes the case before it from *Janus* on the ground that the petitioner was known to the communication's recipients because the petitioner signed his email.[455] But does that mean a lawyer who sends an email to an investor answering a question by stating "my client says to tell you [insert false statement]" can thereby violate Rule 10b-5(a) and (c), even if he or she cannot violate (b), assuming that the lawyer has scienter with respect to the falsehood?[456] What about the lawyer who sends a private placement memorandum ("PPM")—that the lawyer did not write—to potential investors under cover of a letter that the lawyer signs, assuming that the lawyer has scienter with respect to some falsehood in the PPM?

Showing an Efficient Market for Rule 23(b)(3) Class Certification. Plaintiffs in a private Rule 10b-5 action must plead and prove reliance.[457] Unless a private plaintiff can prove reliance on a classwide basis, the need to prove personal reliance by each putative class member will prevent certification of a securities class action under Rule 23(b)(3), which requires that "the questions of law or fact common to class members predominate over any questions affecting only individual members."[458] The Supreme Court held in *Basic Inc. v. Levinson* that a plaintiff can presumptively establish classwide reliance by showing that a misrepresentation became public and that the market in which the relevant security traded was informationally efficient because it reflected public information in the security's price.[459] This is called the fraud-on-the-market ("FOTM") reliance presumption.[460]

In order for the FOTM presumption to apply, the plaintiff must prove the efficiency of the market in which the security traded.[461] Under *Halliburton Co. v. Erica P. John Fund, Inc.*, the order of proof is as follows: First, a Rule 10b-5 plaintiff seeking certification of a Rule 23(b)(3) class case must prove that the security "traded in a generally efficient market."[462] Second, the defendant may then introduce evidence to show that the particular misrepresentation did not impact the security's price—doing so at the class certification stage "for the purpose of countering a plaintiff's showing of market efficiency, rather than directly re-

454. *See supra* note 441 and accompanying text.

455. *See supra* note 446 and accompanying text.

456. In 2016, the Ninth Circuit evinced skepticism in *ESG Capital Partners, LP v. Stratos*, 828 F.3d 1023, 1033 (9th Cir. 2016), that a lawyer can "shield" himself or herself from Rule 10b-5 liability for transmitting a known falsehood by prefacing the misstatement with the phrase that "'[i]t is [my client's] understanding.'"

457. Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2407 (2014).

458. *Id.* at 2406; Fed. R. Civ. P. 23(b)(3).

459. 485 U.S. 224, 241–49 (1988).

460. *Id.* at 245, 249.

461. *Halliburton*, 134 S. Ct. at 2408.

462. *Id.* at 2414.

butting the presumption."[463] Both the plaintiff's proof and the defendant's rebuttal typically center on event studies, which employ statistical techniques to isolate the association of changes in the price of a security with the release of information material to trading in that security.[464]

In 2017, the Second Circuit decided two cases addressing plaintiffs' proof—at the class certification stage—that the market in which the relevant security traded was efficient. Two district court decisions served as a backdrop for the Second Circuit's work. *Cammer v. Bloom* identified five factors to which courts might look when deciding whether a market is efficient enough so that reliance can be established by the FOTM presumption: (1) average weekly trading volume, with "trading of two percent or more of the outstanding shares . . . justify[ing] a strong presumption that the market for the security is an efficient one [and trading of] one percent . . . justify[ing] a substantial presumption"; (2) reports by a "significant number of securities analysts" on the security, which would be "persuasive" that information about the issuer was "closely reviewed by investment professionals" who would make "buy/sell recommendations to client investors" who would, in turn, bid the security up or down to reflect the information; (3) "numerous market makers" who, with "arbitrageurs," would have "react[ed] swiftly to company news and reported financial results by buying or selling stock and driving it to a changed price level"; (4) eligibility of the issuer to use SEC Form S-3, which the Commission designed on the assumption that securities issued by the companies meeting the requirements to use the form trade in an efficient market; and (5) "empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price," which is, "after all, . . . the essence of an efficient market and the foundation for the [FOTM] theory."[465] *Krogman v. Sterritt* added three additional factors for assessing market efficiency; (6) capitalization of the issuer, with the larger the market capitalization the greater the probability the company's securities trade in an efficient market; (7) the bid–ask spread on the security, with the smaller the spread the greater the probability that the security trades efficiently; and (8) the "float," defined as "the percentage of shares held by the public, rather than insiders," with the larger the float the more likely the issuer's security reflects public information because insiders may have nonpublic information that affects their trading so that the smaller the degree to which the traded price is influenced by the insiders, the greater the chance that public information drives its price.[466] Of all eight factors, the fifth—whether "unexpected corporate events or financial releases cause an immediate response in the

463. *Id.* at 2414–15.
464. *Id.*
465. 711 F. Supp. 1264, 1284 (D.N.J. 1989) (discussing the SEC's rationale for Form S-3); *id.* at 1286–87 (the five factors).
466. 202 F.R.D. 467, 474, 478 (N.D. Tex. 2001).

price of a security"—"has been considered 'the most important[ ].'"[467] The fifth factor is the one that directly demonstrates efficiency.

The *In re Petrobras* defendants challenged certification of a class of Rule 10b-5 plaintiffs[468] because the plaintiffs had failed to provide "'any direct evidence of [*Cammer*'s] fifth factor.'"[469] While the plaintiffs' expert "ran multiple event studies and reported that 'there were more likely to be big price movements on days when important Petrobras events occurred, demonstrating [that] the markets in Petrobras securities were responsive to new information,'" the defendants contended these studies did not show market efficiency because they were "non-directional"—i.e., did not determine "'whether the price of a security moved up or down as expected based on the precipitating market event.'"[470] Rejecting the position "that plaintiffs would only be entitled to the *Basic* presumption after making a substantial showing of market efficiency based on directional empirical evidence alone, irrespective of any other evidence they may have offered,"[471] the court of appeals affirmed certification of the Rule 10b-5 class,[472] holding that "indirect evidence" of market efficiency—through the seven factors other than price response to news—"is particularly valuable in situations where direct evidence does *not* entirely resolve the question."[473] But the appellate court stopped short of reaching the "legal question" of "whether plaintiffs may satisfy the *Basic* presumption without *any* direct evidence,"[474] holding that the district court's view—that the "non-directional analysis" provided direct evidence that, supported by the "'indirect *Cammer* factors,'" justified the certification—fell "'within the range of permissible decisions.'"[475] The court of appeals found "no abuse of

467. Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc., 546 F.3d 196, 207 (2d Cir. 2008) (quoting *In re* Xcelera.com Sec. Litig., 430 F.3d 503, 512 (1st Cir. 2005)).

468. 862 F.3d 250, 256–57, 258–59 (2d Cir. 2017). Petrobras, a Brazilian oil and gas company, had seen its value decline dramatically after revelation of "a multi-year, multi-billion-dollar money-laundering and kickback scheme" that resulted in (i) the company overpaying for construction and acquired oil refineries and (ii) artificially inflated asset values on its books. *Id.* at 256–58. Plaintiffs sued, claiming that they were injured in buying both Petrobras ADSs and Petrobras debt securities. *Id.* at 258–59 ("Petrobras Securities" defined to include both ADSs and debt securities; Exchange Act Class certified for "Petrobras Securities").

469. *Id.* at 277 (quoting defendants).

470. *Id.* (quoting district court, *In re* Petrobras Sec. Litig., 312 F.R.D. 354, 367–68, 369 (S.D.N.Y. 2016)). The Second Circuit characterized the defendants' argument so: "not only should putative class plaintiffs be required to offer direct evidence of market efficiency, . . . but the evidence must specifically consist of empirical data showing that the price of the relevant securities predictably moved up in response to good news and down in response to bad news." *Id.*

471. *Id.* at 277–78.

472. *Id.* at 279.

473. *Id.* at 278–79 (noting for example that event studies may find it "difficult to isolate the price impact of any one piece of information in the presence of confounding factors, such as other simultaneously released news about the company, the industry, or the geographic region").

474. *Id.* at 276–77.

475. *Id.* at 277 (first quotation from the district court, *Petrobras*, 312 F.R.D. at 371; second quotation from Roach v. T.L. Cannon Corp., 778 F.3d 401, 405 (2d Cir. 2015)). The plaintiffs sought certification of the Rule 10b-5 claims based on transactions in both Petrobras common and preferred shares and Petrobras debt. For the lower court's analysis of indirect factors, as applied to the claims for fraud affecting the equity transactions, with the analysis considering all eight factors identified in the text at *supra* notes 465–66, *see Petrobras*, 312 F.R.D. at 365–66.

discretion" in the lower court's "consider[ation of] a combination of direct and indirect evidence" in concluding "that Petrobras ADS and Notes both trade in efficient markets."[476]

The Second Circuit then crossed the legal Rubicon in *Waggoner v. Barclays PLC*.[477] Plaintiffs brought a Rule 10b-5 action against the bank and former officers, alleging misleading statements and omissions in descriptions of an alternative trading system, called Barclays LX ("LX"), that supposedly protected users from high-frequency traders, who might "detect patterns involving large incoming trades, and then execute their own trades before those incoming trades are completed," thereby making "the incoming trades . . . more costly or less lucrative."[478] The plaintiffs filed their action shortly after the New York Attorney General commenced a suit against Barclays under the Martin Act, "alleg[ing] that many of Barclays' representations about protections LX afforded its customers from high-frequency traders were false and misleading" and the price of the Barclays American Depository Shares ("ADS") fell by 7.38 percent.[479] The district court certified a Rule 23(b)(3) class, and the Second Circuit granted leave under Rule 23(f) for appeal of that order.[480]

Affirming,[481] the Second Circuit held first that the district court erred in concluding that the plaintiffs could show classwide reliance via *Affiliated Ute Citizens of Utah v. United States*, which held that in a case "involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery."[482] Under those circumstances, "[a]ll that is necessary [to activate a rebuttable presumption of reliance] is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of [the buy/sell] decision."[483]

The Second Circuit found that the *Waggoner* plaintiffs alleged "numerous affirmative misstatements," that the plaintiffs "focus[ed] their claims on those affirmative misstatements," and that "the omissions the Plaintiffs list in their complaint are directly related to the earlier statements Plaintiffs also claim are false."[484] As an example, the plaintiffs alleged that the defendants falsely stated that the "Liquidity Profiling" feature of LX—which "purportedly allowed Bar-

476. *Petrobras*, 862 F.3d at 279. But class members who had purchased Petrobras Notes (which were not traded on any exchange) had to prove that their purchases were "domestic" within the meaning of *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247, 267 (2010), and the Second Circuit held that the district court should have considered whether questions of individualized proof of such transactional domesticity prevented a finding, as to those class members, that common questions of law and fact predominated over questions raised by claims of particular class members. *Id.* at 270–75. The court remanded for a robust consideration of that question. *Id.* at 274–75, 279.

477. 875 F.3d 79 (2d Cir. 2017), *cert. denied*, No. 17-1209, 2018 WL 1116150 (Apr. 30, 2018).

478. *Id.* at 84–86.

479. *Id.* at 88.

480. *Id.* at 92.

481. *Barclays*, 875 F.3d at 107.

482. *Id.* at 95–96; Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972).

483. *Affiliated Ute*, 406 U.S at 153–54; Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159 (2008) (*Affiliated Ute* presumption is rebuttable).

484. *Barclays*, 875 F.3d at 96.

clays' personnel to monitor high-frequency trading in LX more closely and permitted traders to avoid entities that engaged in such trading,"—"protected LX traders."[485] The plaintiffs' alleged omission "that Barclays failed to disclose that Liquidity Profiling did not apply to a significant portion of the trades conducted in LX" was "simply the inverse" of that misrepresentation.[486] The court of appeals accordingly concluded that the district court "erred by . . . appl[ying]" the *Affiliated Ute* presumption[487] because that "presumption does not apply to earlier misrepresentations made more misleading by subsequent omissions, or to what has been described as 'half-truths,' nor does it apply to misstatements whose only omission is the truth that the statement misrepresents."[488]

Turning second, and most pertinent here, to the defense argument that the district court improperly concluded that the plaintiffs could prove classwide reliance via the FOTM presumption, the Second Circuit confronted "the district court's decision not to rely on direct evidence of price impact under *Cammer*['s]" fifth factor at all, finding that conclusion to "f[a]ll comfortably within the range of permissible decisions."[489] Specifically, the appellate court held that "a plaintiff seeking to demonstrate market efficiency need not always present direct evidence of price impact through event studies."[490] Although conceding that its previous opinions had "recognized that *Cammer*['s fifth factor] has been considered the most important *Cammer* factor in certain cases," the Second Circuit distinguished such opinions as concluding that the importance of *Cammer*'s fifth factor in them "was greater because a number of the indirect *Cammer* factors suggested the inefficiency of the market,"[491] whereas here "[a]ll seven of the indirect factors considered by the district court (the first four *Cammer* factors and the three *Krogman* factors) weighed so clearly in favor of concluding that the market for Barclays' ADS was efficient that the Defendants did not even challenge them."[492] "Under the[se] circumstances . . . , the district court was not required to reach a conclusion concerning direct evidence of market efficiency."[493]

The final question revolved around the right to rebut the FOTM presumption, with the defendants contending that simply producing evidence contesting the presumption should be sufficient for rebuttal, and the district court holding that the sufficient plaintiffs' showing of market efficiency had "shift[ed] the burden of persuasion, rather than the burden of production."[494] The Second Circuit rejected the defense argument, ruling that "[t]he presumption of reliance would . . . be of little

485. *Id.* at 87–88, 96.
486. *Id.* at 96.
487. *Id.* at 95.
488. *Id.* at 96.
489. *Id.* at 98.
490. *Id.* at 97.
491. *Id.*
492. *Id.* at 98.
493. *Id.* at 99. Find the district court's sparse analysis of the indirect factors at *Strougo v. Barclays PLC*, 312 F.R.D. 307, 323 & nn.102–04 (S.D.N.Y. 2016). Like the district court, the Second Circuit relied primarily on the high average trading volume and the large number of analysts. *Barclays*, 875 F.3d at 99.
494. *Id.* at 99.

value if it were so easily overcome" as the defendants contended.[495] The court of appeals read the "Supreme Court guidance" to "indicate[] that defendants seeking to rebut the [FOTM] presumption must demonstrate a lack of price impact by a preponderance of the evidence at the class certification stage rather than merely meet a burden of production."[496]

The defendants relied in part on Federal Rule of Evidence 301, which provides that "[i]n a civil case, unless a federal statute or these rules provide otherwise, the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption. *But this rule does not shift the burden of persuasion, which remains on the party who had it originally*."[497] The Second Circuit, however, found that the FOTM presumption falls into Rule 301's exception for "a federal statute" because it "was adopted by the Supreme Court pursuant to federal securities laws."[498]

Applying the rule that rebuttal of the presumption requires proving that the alleged misrepresentations did not affect the price, the court held that the trial court did not abuse its discretion in determining that the defendants had not carried their burden by showing that "the alleged misstatements did not affect the price of Barclays' ADS."[499] Since the plaintiffs "proceeded on a price maintenance theory"—that the misrepresentations sustained an inflated price rather than further inflating it—"the district court was well within its discretion in concluding that the lack of price movement on the dates of the alleged misrepresentations does not rebut the [FOTM] presumption."[500] While the defendants also argued that "the decline in the [ADS] price . . . following the disclosure of the New York Attorney General's action was due 'to potential regulatory action and fines, not the revelation of any allegedly concealed truth,'" the Second Circuit found that the district court acted within its discretion in concluding that defendants had not satisfied their burden of proving no price impact with this argument either.[501] The defense expert only asserted "that '*some* of the price reaction was independent of the specific allegations relating to LX,' and was instead 'a response to the regulatory action itself.'"[502] To this, the court responded: "merely suggesting that another factor *also* contributed to an impact on a security's price does not establish that the fraudulent conduct complained of did not also impact the price of the security."[503]

495. *Id.* at 100–01.

496. *Id.* at 101–02. The Second Circuit held, directly, "that defendants must rebut the *Basic* presumption by disproving reliance by a preponderance of the evidence at the class certification stage." *Id.* at 99.

497. *Id.* at 102–03 (quoting Fed. R. Evid. 301) (emphasis added).

498. *Id.* at 103.

499. *Id.* at 104.

500. *Id.*

501. *Id.*

502. *Id.* (quoting defense expert) (emphasis added by the Second Circuit).

503. *Id.* As the district court had put it, "[t]he 'fact that other factors contributed to the price decline does not establish *by a preponderance of the evidence* that the drop in the price of Barclays['] ADS was not caused *at least in part* by the disclosure of the fraud at LX[.]'" *Id.* at 92 (quoting district court,

Significance and analysis. The Second Circuit's inclination to discourage class action analysis dominated by competing expert witnesses who debate their event studies may seem admirable.[504] But courts must be careful. As the Second Circuit acknowledged, statistically sound showings that material information has moved the price of a stock is *direct* evidence of informational market efficiency, and, should remain the gold standard for a plaintiff showing that the relevant security traded in an efficient market.[505] Resort to the "indirect" evidence from the other seven factors not only necessitates intellectual reliance on an inference, but should be tempered by skepticism as to those factors as well. For example, the "strong presumption" of market efficiency from weekly trading of 2 percent or more of outstanding shares, with 1 percent supporting a "substantial presumption," traces back to a remark in a treatise that cited no data or study to justify the significance of those levels.[506]

Moreover, courts should not lose sight of the normative component of the reliance element to which the FOTM presumption attaches. Reliance must be reasonable or justifiable.[507] Even accepting that market efficiency is limited to informational efficiency rather than value efficiency,[508] the response of a security's price to information must make sense in order that buyers and sellers rely on that price to convey misstatements. The notion in *Petrobras* that non-directional price change proof can show market efficiency—i.e., that a market for a security can be proved efficient by showing that the price of the security changed, even if "good" news was associated with price decreases and "bad" news was associated with price increases[509]—defies this normative constraint. That is, it is difficult to understand how investors can *justifiably* rely on market price to convey information if the price is reflecting good news in price drops and bad news in price pops.

One advantage of pegging market efficiency to event studies is to divorce the analysis from impressionistic decision making. The suspicion that some panels may entertain of numerically driven conclusions should not move courts to in-

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Strougo v. Barclays PLC, 312 F.R.D. 307, 327 (S.D.N.Y. 2016)) (emphasis added by the Second Circuit).

The court also rejected the defense argument that the district court wrongfully concluded that the plaintiffs could prove classwide damages. *Id.* at 105–06.

504. *In re* Petrobras Sec. Litig., 862 F.3d 250, 277 (2017) (noting the district court characterization of the class action motion as a contest of "'sparr[ing]'" experts (quoting *In re*: Petrobras Sec. Litig., 312 F.R.D. 354, 367 (S.D.N.Y. 2016))), *petition for cert. filed*, No. 17-664 (U.S. Nov. 3, 2017). *See also* the court's reference to "[e]vent studies offer[ing] the seductive promise of hard numbers and dispassionate truth." *See supra* note 473.

505. *See supra* note 467 and accompanying text.

506. *See* William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 Emory L.J. 843, 859, 864 & n.59. (2005).

507. 4 Thomas Lee Hazen, Treatise on The Law of Securities Regulation § 12.90 (2017) ("As is the case with fraud actions generally, in a securities fraud case, any reliance by the plaintiff must be reasonable.").

508. *In re* PolyMedica Corp. Sec. Litig., 432 F.3d 1, 12–16 (1st Cir. 2005), *overruled by* Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 568 U.S. 455 (2013), to the extent that *PolyMedica* suggested in dicta (at 7 n.11) that a plaintiff seeking to invoke the FOTM presumption must prove on class certification that the misrepresentations were material.

509. *See supra* note 470 and accompanying text.

tellectually unconstrained results. The move away from what the Second Circuit characterizes as the "*Cammer* 5" factor[510] should be cautious.

Loss Causation in Rule 10b-5 Cases. A Rule 10b-5 private plaintiff must plead and prove loss causation.[511] In open market cases, a plaintiff typically proves such causation by a price change following revelation of the truth behind the fraud or the omitted material fact that the defendant had a duty to reveal, but did not ("corrective disclosure").[512] Courts of appeals have for years debated the conditions under which the announcement of a government investigation, and a resulting stock price drop, shows loss causation where the investigation concerns the subject matter of the fraud that the plaintiff alleges.[513] The controversy revolves significantly around the truth that "[t]he announcement of an investigation reveals just that—an investigation—and nothing more," certainly not that "a company's previous statements were false or fraudulent."[514]

In 2017, the Ninth Circuit addressed whether loss causation could be moved back yet another step: rejecting the argument that disclosure of customer complaints to a federal agency, followed by a stock price drop but no investigation, could provide corrective disclosure.[515] The Sixth Circuit found that, under the particular circumstances in the case before it, the filing of a civil lawsuit against the issuer—in a case other than a suit by investors—could constitute corrective disclosure.[516]

The *Curry v. Yelp Inc*. plaintiffs alleged that Yelp falsely represented "that the reviews generated on Yelp's website were 'firsthand' and 'authentic' information from contributors about local businesses,"[517] whereas the plaintiffs alleged that Yelp manipulated the reviews to increase its advertising revenue by, for example, removing good reviews of companies that did not advertise on Yelp and suppressing bad reviews for those that did.[518] Affirming dismissal,[519] the Ninth Circuit held that the plaintiffs had failed to adequately allege loss causation by pleading a 6 percent drop in the price of Yelp stock after the Federal Trade Commission ("FTC") and *Wall Street Journal* "disclosed more than 2,000 complaints

510. Waggoner v. Barclays PLC, 875 F.3d 79, 89 (2d Cir. 2017), *cert. denied*, No. 17-1209, 2018 WL 1116150 (Apr. 30, 2018).

511. 15 U.S.C. § 78u-4(b)(4) (2012); Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

512. *See Dura*, 544 U.S. at 344; *see also* Pub. Emps.' Ret. Sys. of Miss. v. Amedisys, Inc., 769 F.3d 313, 320–21 (5th Cir. 2014).

513. *See* Lloyd v. CVB Fin. Corp., 811 F.3d 1200, 1209–11 (9th Cir. 2016); *Amedisys, Inc.*, 769 F.3d at 318–19 (detailing the disclosures), 323–24 (quoting the court's rationale).

514. Loos v. Immersion Corp., 762 F.3d 880, 890 (9th Cir. 2014) (quoting Meyer v. Greene, 710 F.3d 189, 1201 (11th Cir. 2013)).

515. *See infra* notes 517–22 and accompanying text.

516. *See infra* notes 523–35 and accompanying text.

517. 875 F.3d 1219, 1222–23, 1225–26 (9th Cir. 2017).

518. The plaintiffs "allege[d] that Yelp employees attempted to coerce businesses into buying advertising in exchange for offers to remove fake negative reviews and manipulated businesses' reviews as retribution for refusing to buy advertisements." Curry v. Yelp Inc., No. 14-cv-03547-JST, 2015 WL 7454137, at *2 (N.D. Cal. Nov. 24, 2015).

519. *Yelp*, 875 F.3d at 1228.

from businesses claiming that Yelp had manipulated reviews of their services," more than 1,300 of which had not been previously revealed.[520]

Referencing the general rule "that the mere announcement of an investigation [is] insufficient to establish loss causation because it does not '"reveal" fraudulent practices to the market,'" the Ninth Circuit remarked: "Plaintiffs rely on even less, as they only cite customer complaints to the FTC without a subsequent investigation."[521] Focusing on the required connection between loss and fraud, the court of appeals held that "the element of loss causation cannot be adequately made out merely by resting on a number of customer complaints and asserting that where there is smoke, there must be fire."[522]

In *Norfolk County Retirement System v. Community Health Systems, Inc.*, the Sixth Circuit considered whether the filing of a civil complaint might provide corrective disclosure.[523] The plaintiffs alleged Rule 10b-5 fraud by Community Health Systems ("Community") through statements by the company and individual officer defendants "attribut[ing] its profits to the 'synergies' and 'efficiencies' of its hospital network," whereas, in fact, the profits depended significantly on criteria that Community developed and memorialized in what it called the "Blue Book"—criteria that called for admission of patients for inpatient services when they displayed symptoms to which other hospitals would respond with outpatient care, with the result that Medicare paid Community more money for that inpatient treatment than it paid to other hospitals for their outpatient treatment.[524] The plaintiffs alleged loss causation by (i) a 35 percent decline in Community's stock price after Tenet Healthcare Corporation, which was resisting a hostile takeover attempt by Community, filed an April 11, 2011 complaint alleging that Community was misleading Tenet shareholders in a proxy fight by touting Community's profits without disclosing (a) use of the Blue

520. *Id.* at 1222, 1225 (noting allegations "that 1,344 of the 2,046 complaints the FTC disclosed had not been previously disclosed and corroborated each other, and that the FTC disclosures showed that the rate of complaints had increased").

521. *Id.* at 1225 (quoting Loos v. Immersion Corp., 762 F.3d 880, 890 (9th Cir. 2014)).

522. *Id.* The court held also that the complaint did not adequately allege scienter. No allegation charged "that an Individual Defendant had specific information regarding employee use of review manipulation when trying to sell advertising," and—given that a securities analyst report stated that Yelp "had 53 million reviews on its platform," "[t]wo thousand complaints represented one complaint in every 26,500 reviews," so "small [a] portion of Yelp's business [that the number did] not support a strong inference of scienter." *Id.* at 1227–28. Nor did the complaint allege stock sales supporting scienter, because the naked assertion of large absolute stock sales is not suspicious absent allegations of stock sale history showing that the class period sales were abnormally large; and here, the plaintiffs included no such histories. *Id.* at 1226–27. Moreover, "the vast majority of Individual Defendants' stock sales were made pursuant to a Rule 10b5-1 plan." *Id.* at 1226 n.2.

523. 877 F.3d 687 (6th Cir. 2017).

524. *Id.* at 690–91, 694 (claim brought under Rule 10b-5). Other hospitals used criteria developed by independent companies and compiled in the InterQual Criteria and the Milliman Care Guidelines. *Id.* at 690. "The Blue Book directed doctors to provide inpatient services for many conditions that other hospitals would treat as outpatient cases under InterQual or Milliman." *Id.* at 690. Community's chief medical officer in 2007—after Community acquired hospitals from another company—said that insurers "would be skeptical about paying for inpatient services if [the hospitals so acquired] switched from InterQual" to the Blue Book. *Id.* at 691. And "Community's own Medicare consultant told management that the Blue Book put the company at risk of a fraud suit." *Id.*

Book, (b) the consequent admission of patients for in-hospital as opposed to outpatient care, and (c) the resulting profit inflation from what amounted to Medicare fraud and (ii) an 11 percent stock price decline following Community's October 26, 2011 press release disclosing lower year-over-year third quarter revenue, with the Community CFO admitting in a related conference call that the decline was related to "phasing out the Blue Book."[525]

Focusing on the complaint that Tenet filed, the district court dismissed the shareholder action for failure to plead loss causation, reasoning that the "complaint could not reveal the truth behind the[] prior alleged misrepresentations because complaints can reveal only allegations rather than truth."[526] Reversing,[527] the Sixth Circuit conceded that this analysis "might have merit as a general rule," but found "two aspects of the Tenet complaint [that] set it apart from most complaints for purposes of [loss causation] determination."[528] First, Community's CFO admitted to an analyst on the date that the complaint was filed that it was true to the extent that it alleged "that Community's hospitals did in fact use the Blue Book," although he "claimed that about 30 of Community's hospitals had already stopped using it, and that the rest would do so by the end of the year—without losing revenue."[529] The court of appeals found it "easily plausible that [the CFO's] admission, together with the relevant allegations in the Tenet complaint, revealed a material fact that Community had previously concealed from the market."[530] Second, the Tenet complaint described reports provided by two healthcare consulting firms that Tenet had retained and who concluded that the discrepancy—between the proportion, at Community, of patients admitted to hospital versus the proportion treated through outpatient services, and the national average of those proportions—could not be explained by any factor other than that "'patients whose medical needs likely required treatment in outpatient observation . . . were systematically admitted for higher-paying inpatient treatment at [Community's] hospitals.'"[531] This conveyed new information to the market, namely "that Community not only admitted more inpatients than other hospitals, but did so in a manner that was clinically improper."[532] The Sixth Circuit found it "at least plausible, therefore, that the expert analyses in the Tenet complaint revealed a truth that Community had until then fraudulently concealed: that the Blue Book had improperly inflated Community's inpatient admissions and thus its profits."[533] All in all, the court of appeals found the complaint to "plausibly allege[] corrective disclosures

525. *Id.* at 691–92, 695–96.
526. *Id.* at 696.
527. *Id.* at 698.
528. *Id.* at 696.
529. *Id.* at 692, 696.
530. *Id.* at 696. The court analogized this case to one "where the announcement of an SEC investigation, in addition to an admission by the defendant, amounted to a corrective disclosure." *Id.*
531. *Id.* at 691 (alteration by the court), 697.
532. *Id.* at 697.
533. *Id.*

that revealed the defendants' antecedent fraud to the market and . . . thereby caused the plaintiffs' economic loss."[534]

Significance and analysis. As the Sixth Circuit suggested,[535] whether news proves to be a corrective disclosure or not depends on the market's assessment of the probability that the news reveals that the defendant misrepresented in the past or misled by omission. While a court itself must assess that probability in each case, it is possible to identify some pertinent factors. They include, when considering whether disclosure of a government investigation or lawsuit might be a corrective event: (i) the degree to which the disclosure shows the investigation or lawsuit to relate to the alleged misrepresentations or omissions, (ii) all circumstances that bear on the likelihood that the concerns prompting the investigation or the allegations in the lawsuit should be credited, (iii) stock price changes following the news of the investigation or lawsuit, and (iv) facts showing that market participants reacted *because* they perceived a heightened probability of the particular fraud that the plaintiff alleges. Strangely, *Community Health Systems* does not address the effect of context of the Tenet lawsuit. The narrative suggests that that lawsuit was part and parcel of a takeover defense. Given that litigators can almost always find a pliable expert to render a helpful opinion, the inclusion of an "expert analysis" in such a complaint seems, by itself, to add little. The market reaction—dropping Community's stock price—seems the best indicator that the lawsuit was a corrective event within the meaning of loss causation analysis, but it would have been helpful if the Sixth Circuit had addressed the possibility that the stock price decline constituted a reassessment of the likelihood that Community would succeed in its hostile takeover attempt rather than a recognition of risk that Community's prior profits were inflated by wrongful admission practices.

Life Sciences Companies' Interactions with the Food and Drug Administration. Drug and medical device manufacturers communicate often and at length with the FDA as they move new medicines and physical aids to market, and thereafter. The critical importance of these interactions—particularly for companies that have but one or two drugs or devices somewhere in the lengthy testing process before licensing—makes company disclosures about meetings and written communications with the FDA of keen interest to investors. This summary accordingly devotes this special section to the 2017 cases from the life sciences sector.[536]

Last year, the Third Circuit affirmed dismissal of a case based on a drug company's failure to disclose that the FDA would require an outcomes study, not just a study testing for the drug's effect on a surrogate endpoint, in order to approve the drug because the FDA had not rejected the endpoint until after the defen-

534. *Id.* at 698.

535. *Id.* at 696 ("As an initial matter, every representation of fact is in a sense an allegation, whether made in a complaint, newspaper report, press release, or under oath in a courtroom. The difference between those representations is that some are more credible than others and thus more likely to be acted upon as truth.").

536. In addition, see the description of the *Biogen* decision in *supra* note 314.

dants made the challenged statements.[537] The First Circuit affirmed dismissal where the company represented that the FDA was open to reviewing data on a surrogate endpoint but also disclosed that the FDA had not committed to accept that endpoint as a predictor of clinical benefit.[538]

The Third Circuit affirmed dismissal of a Rule 10b-5 case brought by the *In re Amarin Corp. PLC Securities Litigation* plaintiffs, who claimed they were misled by the company's failure to disclose that the FDA would require the company to complete a cardiovascular outcomes study before the FDA would approve use of the defendants' drug ("Vascepa") to reduce cardiac events such as heart attacks in patients with elevated triglycerides ("TGs") who were taking a statin drug like Lipitor (the "Vascepa heart-benefit use").[539] The company sought approval based on a twelve-week clinical trial. The length of that trial was insufficient to measure the effect of the therapy on cardiovascular outcomes. Instead, the company designed the trial to measure the effect on TGs, on the theory that a "reduction of TGs" was "a 'surrogate endpoint'" because "a significant reduction of TGs would lead to reduced major adverse cardiac events."[540]

In July 2008, company officials met with the FDA, and the FDA's minutes of that meeting (the "2008 Minutes") recorded that (i) the agency "was 'not aware' of any long-term outcomes trials demonstrating that the reduction of TGs in patients on statin therapy significantly reduces the risk of major adverse cardiac events," (ii) the FDA was aware of three ongoing studies that might shed light on the relationship of TGs to cardiac events, and (iii) the agency told the company "that 'before [it] would entertain granting [approval for Vascepa heart-benefit use],' [the company] would 'at a minimum' have to submit data from the [twelve-week] Study and 'initiate an appropriately-designed cardiovascular outcomes study' that was 'well under way' by the time the FDA began its review."[541]

In 2009, the company entered into a Special Protocol Assessment with the FDA regarding the design of the twelve-week study (the "2009 SPA"), in which the FDA "agreed with the proposed 'design' of the [twelve-week] Study, including [the company's] proposed 'endpoints.'"[542] However, the FDA said that the key question—whether the statistically significant results from the company's proposed twelve-week study "would 'provide an adequate basis for approval'"—would be "'a review issue.'"[543]

After two of the three studies to which the 2008 Minutes referred failed to establish a relationship between TGs and cardiac events, the FDA advised the com-

537. *See infra* notes 539–68 and accompanying text.

538. *See infra* notes 569–92 and accompanying text. The drug had already been approved for a different use. *See* Press Release, Amarin, Amarin Announces FDA Approval of Vascepa (icosapent ethyl) Capsules for the Reduction of Triglyceride Levels in Adult Patients with Severe Hypertriglyceridemia (July 26, 2012), *available at* http://investor.amarincorp.com/releasedetail.cfm?releaseid=696027.

539. 689 F. App'x 124, 125–27, 133 (3d Cir. 2017).

540. *Id.* at 125.

541. *Id.* at 126 (quoting the 2008 Minutes).

542. *Id.* (quoting the 2009 SPA).

543. *Id.*

pany on April 14, 2011 "that an advisory committee 'was likely before the [approval of Vascepa heart-benefit use] could possibly be granted.'"[544] Four months later, the FDA entered into a second SPA (the "2011 SPA").[545] This SPA "cover[ed] the design and endpoints of the long-term outcomes study" that the 2008 Minutes had said must be underway by the time the agency began its review of the twelve-week study.[546] Once again, the FDA "declined to commit to [the] criteria" for approving Vascepa for use by high-TG patients taking statin drugs.[547]

In February 2013, with the long-term outcomes study "substantially underway," the company submitted its application for the Vascepa heart-benefit use approval.[548] The advisory committee that the FDA convened in October of that year "voted to reject the [company's] application because it found that there was insufficient data to support the use of reducing TGs as a surrogate endpoint," and the FDA shortly thereafter rescinded the 2009 SPA.[549] The company unsuccessfully appealed this decision within the FDA.[550]

The plaintiff claimed that fourteen statements over the class period from November 29, 2010 through October 16, 2013 "represented that a long-term outcome[s] trial . . . was 'not required' to be completed or that the Defendants '[did] not believe' one '[would] be required' to be completed before the FDA" granted the approval.[551] The plaintiff contended that the statements were "false and misleading because the FDA had indicated approval would be a 'review issue,' and that an outcomes trial, 'given the failure of [two of the three studies seeking a link between TGs and cardiac event], [was] almost certainly going to be required by the FDA prior to approval [of Vascepa for heart benefit use].'"[552] The plaintiff further contended that the defendants had aggravated the misleading nature of these statements by expressing optimism that the FDA would grant the approval.[553]

Agreeing with the district court,[554] the Third Circuit found that the complaint did not plead that the statements were false or misleading because, "[v]iewed in their entirety," the allegations "and documents incorporated by reference reveal that TG lowering, despite the open nature of the scientific question, remained a viable surrogate endpoint until 2013."[555] The 2008 Minutes did not show that the FDA took the position that a reduction in TGs "was not a valid surrogate" for reduction in adverse cardiovascular events.[556] To the contrary, when the FDA

544. *Id.*
545. *Id.*
546. *Id.*
547. *Id.*
548. *Id.*
549. *Id.* at 126–27.
550. *Id.* at 127.
551. *Id.*
552. *Id.*
553. *Id.* at 127–28.
554. *Id.* at 128.
555. *Id.* at 129.
556. *Id.* at 129–30.

rejected the company's appeal of the ultimate denial, a doctor "confirmed that 'at the time of the [2008 Meeting], (as well as at the time of the [2009] SPA agreement) [the FDA] was still willing to accept TG lowering as a validated surrogate for reducing CV risk. . . .'"[557] The 2009 SPA amounted to the FDA's agreement with this surrogate endpoint.[558] Entry by the FDA into the 2011 SPA confirmed that the FDA was "still willing to consider the [company's] application on this theory" even after two studies had failed to confirm the relationship between TGs and adverse heart events.[559] As the court saw it, then, "the FDA never explicitly or even implicitly indicated that a long-term outcome trial would be required to be completed for approval," but only "wished to see that a long-term study was 'well under way'" before considering Vascepa's approval for heart benefit.[560] The "FDA did not conclusively reformulate its thinking on the state of the scientific literature supporting the TG lowering hypothesis until after it considered the 'new' scientific evidence in 2013," as shown by statements in the agency's decision to rescind the 2009 SPA, such as "that '[the] weight of evidence *no longer supports*' the use of TG lowering as a surrogate endpoint because of the 'important new scientific evidence.'"[561]

The court therefore rejected the "allegation that the FDA was 'certain' to require an outcomes study at the time of the Defendants' statements."[562] The Third Circuit then went on to note that the defendants "never expressly stated or implied that the 2009 SPA guaranteed approval, or that the FDA had conclusively accepted TG lowering as a validated surrogate during the Class Period."[563] Finally, as to the defendants' optimism, "the 2008 Minutes, taken in context," provided "a reasonable basis for believing the FDA would approve" Vascepa for the treatment the company sought.[564]

Significance and analysis. In 2016, the Second Circuit decided *Tongue v. Sanofi*.[565] That decision applied the *Omnicare* analysis[566] to projections of FDA approval in an action under both section 11 of the Securities Act and Rule 10b-5.[567] *Amarin*'s only acknowledgment of the Supreme Court's guidance on opinions is a footnote "declin[ing] to decide whether *Omnicare* is applicable to § 10(b) claims," adding the Delphic note that "even under the principles set forth in the Supreme Court's opinion in that case, our decision here would remain unchanged."[568] It is likely

557. *Id.* at 130 (quoting from the FDA's decision letter on the appeal).
558. *Id.*
559. *Id.*
560. *Id.*
561. *Id.* at 130–31 (quoting from the decision to rescind) (emphasis added by the court).
562. *Id.* at 131.
563. *Id.* (footnotes omitted). In fact, the company warned investors to the contrary. *Id.* at 131–32 (quoting from 10-Ks).
564. *Id.* at 132.
565. 816 F.3d 199 (2d Cir. 2016).
566. *See supra* notes 334–39 and accompanying text.
567. *Sanofi*, 816 F.3d at 202–03, 209–14.
568. *Amarin*, 689 F. App'x at 132 n.12. As noted elsewhere, the Ninth Circuit last year held that *Omnicare*'s analysis does apply to determine whether opinions challenged in Rule 10b-5 cases are false or misleading. *See supra* notes 340–64 and accompanying text.

that the *Omnicare* analysis will be used to test life sciences companies' opinions about FDA positions and predictions of FDA action in the future. Practitioners counseling companies on their disclosures may wish to use that analysis now.

In a case somewhat similar to *Amarin*, in that the company's testing focused on a surrogate endpoint rather than a reduction in the targeted disease or its symptoms, the plaintiffs in *Corban v. Sarepta Therapeutics, Inc.* alleged that Sarepta Therapeutics ("ST"), its CEO, and its Chief Medical Officer committed Rule 10b-5 fraud by statements between July 24, 2013, and November 11, 2013, suggesting that the FDA would accept its New Drug Application ("NDA") for a muscular dystrophy drug.[569] On November 12, ST disclosed that the FDA had "stated that it viewed 'an NDA filing for [the drug] as premature.'"[570] ST's stock price dropped by 64 percent.[571]

In affirming dismissal on the basis that the complaint failed to adequately plead scienter,[572] the First Circuit focused on ST's July 24, 2013 disclosures concerning its meeting with the FDA the day before, and two statements by the CEO in August and September.[573] On July 24, ST issued a press release about the previous day's meeting, and the CEO said "that he was 'encouraged by the feedback from the FDA,' that he believed 'that data from [ST's] ongoing clinical study . . . will be sufficient for an NDA filing,' and that the FDA indicated that it was 'open to considering an NDA filing based on the data [ST had] shared with [the FDA] to date.'"[574] The plaintiffs attacked these statements on the ground that they misled by failing to add that, in the July meeting and in an earlier one in March, "FDA officials . . . voiced 'a number of concerns' to be addressed prior to filing, and articulated 'strong reservations' about the type of data upon which [ST] was relying."[575] Characterizing the challenged statements as "convey[ing] more opinion than fact," the First Circuit pointed to the many caveats with which the defendants accompanied those statements, including cautions in the July 24 press release "that the FDA 'requested additional information related to the methodology and verification of [the quantity of a protein that the drug would prompt the patient's body to produce and that was essential for muscle function] . . .[,]' . . . 'would not commit to declaring [that protein] an acceptable surrogate endpoint,' and that a decision to allow the filing of an NDA 'would not indicate that [the FDA had] accepted [the protein's] expression

569. 868 F.3d 31 (1st Cir. 2017); *id.* at 33 (case based on expression of "conditional optimism that the FDA would accept [ST's] application"); *id.* at 35 (identifying individual defendants); *id.* at 37 (identifying cause of action and class period).

To gain approval for a new drug, a life sciences company must submit a new drug application ("NDA"). 21 U.S.C. § 355(a) (2012). A submitted application is not "filed" unless the FDA makes "a threshold determination that the NDA is sufficiently complete to permit a substantive review." 21 C.F.R. § 314.101(a)(1) (2017).

570. *Corban*, 868 F.3d at 36.

571. *Id.*

572. *Id.* at 33, 43.

573. *Id.* at 38–40.

574. *Id.* at 38.

575. *Id.*

as a biomarker reasonably likely to predict clinical benefit.'"[576] The court added that the ST stock price declined by 19 percent "on July 24 from its closing price the day before," suggesting that "[i]nvestors apparently paid more attention to those caveats than to the news that the FDA was open to considering an NDA based on [ST's] Phase IIb trial data."[577] Looking at the July disclosures in whole, the First Circuit found, instead of fraud, "[a]t worst, [a] positive spin that put more emphasis in tone and presentation on the real signs of forward movement with the NDA than it did on causes for wondering if the journey would prove successful."[578]

Moving to the CEO's statements later in the year, that executive said on August 15, 2013, "that [ST] had shared its [protein] data with the FDA (which is not disputed) and that the data 'was not something that was questioned or challenged in terms of [ST's] method for quantifying.'"[579] On September 9, "he said in reference to the FDA's proposal to conduct additional biopsies of the Phase IIb study participants that the proposal 'was not an indication of the lack of strength of [ST's] current biopsy analysis and data.'"[580] While the plaintiffs attacked these statements as failing to disclose the March 2013 "communications from the FDA expressing the agency's skepticism about [ST's] quantification of [the muscle function protein]," ST had, after the March communications, "submitted additional data to the FDA in compliance with FDA requests, and the agency's skepticism was fairly viewed as having diminished."[581] And the plaintiffs' attack on the CEO's statement that the FDA had not challenged the "method for quantifying" the protein failed because the FDA was not concerned with the "*method*" of quantification but only suggested that the measurements be confirmed by an independent laboratory rather than relying solely on biopsies obtained and processed by one technician at one study site.[582] The plaintiffs' conflation of measurement reliability with study methodology "in order to demonstrate scienter," the court concluded, "fall[s] flat."[583]

576. *Id.* The company's notional physiological mechanism, expressed diagrammatically, was: drug→production of protein→more moderate muscular dystrophy and longer life expectancy. *Id.* at 34. While the press release "stated that [ST] planned to submit an NDA 'in the first half of 2014,'" the company also "cautioned in its communications that the exact timing of the NDA submission was unknown, that the [FDA] did not yet endorse the [protein] surrogate endpoint under the accelerated approval pathway, and that in any event '[a] filing would only indicate that the question [of the propriety of ST's protein surrogate endpoint] merits review.'" *Id.* at 35–36.

The CEO not only "communicated 'excite[ment],' stating that the company was 'very encouraged by the FDA feedback' and hopeful that the agency 'would accept [an NDA] for filing' . . . [; he also] emphasized [ST]'s 'belie[f] that [the protein] is a viable surrogate marker,' characterizing the company's [protein] analysis as 'robust.'" *Id.* at 35. On the other hand, like the company, the CEO added cautions by "accurately report[ing] that the FDA declined to offer 'any guarantee or assurance that an NDA submission would be acceptable for filing.'" *Id.* at 38.

577. *Id.* at 36.
578. *Id.* at 38.
579. *Id.* at 39.
580. *Id.*
581. *Id.*
582. *Id.* at 39–40.
583. *Id.* at 40.

The First Circuit similarly found no strong inference of scienter arising from allegations that the defendants had a motive to misrepresent because doing so would maintain ST's stock at an attractive level for the company's July 2013 at-the-market stock offering, the proceeds from which ST planned to use "'for general corporate purposes.'"[584] The complaint failed to plead that ST needed that money for "continued operations," and certainly no facts from which to infer that it "would shutter its doors unless it . . . deceiv[ed] investors."[585] Without such allegations of particular and urgent need, the plaintiffs offered nothing more than a general motive to improve financial results, which is insufficient to show scienter.[586] The plaintiffs offered the additional motivation that ST hoped, through its optimistic statements, to "catalyze[] families and advocates of boys suffering from [the particular kind of muscular dystrophy at which the drug was aimed] to pressure the FDA for accelerated approval."[587] But "given that outside pressure on the FDA plays no clear or generally acknowledged role in the agency's closely regulated process, . . . it seems a stretch to infer that the defendants risked closer scrutiny simply to apply indirect pressure on a regulator's data-driven decision[-]making process."[588]

Lastly, the overall narrative tilted away from fraud or recklessness of the sort that suffices for scienter under Rule 10b-5.[589] Instead, the "[m]ore plausible . . . [and] opposing innocent inference [is] that the defendants, perhaps negligently, waxed too optimistically about the FDA's expression of a willingness to consider an NDA . . . while emphasizing too little the FDA's reservations about such an application."[590]

Significance and analysis. The opinion includes industry-friendly passages saying that "[t]he defendants had no legal obligation to loop the public into each detail of every communication with the FDA" and "simply pointing us to omitted details [in company-FDA communications] . . . and failing to explain how the omitted details rendered the particular disclosures misleading, misses the mark."[591] But the court decided the case and included these comforting words in a context that included FDA acceptance of an NDA, after the class period ended, and "accelerated approval for [the drug] on September 19, 2016."[592]

584. *Id.* at 41–42 (quoting complaint, in turn quoting ST announcement).
585. *Id.* at 42.
586. *Id.* at 41.
587. *Id.* at 42.
588. *Id.*
589. *Id.*
590. *Id.*
591. *Id.* at 40.
592. *Id.* at 37. Two other life sciences decisions deserve mention, both decided by the First Circuit. In one opinion, the court affirmed a district court dismissal on the ground that the complaint failed to plead false or misleading statements. Ganem v. InVivo Therapeutics Holdings Corp., 845 F.3d 447, 450, 457 (1st Cir. 2017). The plaintiff alleged that the company's projected schedule for a clinical test was unrealistic because of conditions that the FDA placed on the test and that the company did not disclose. *Id.* at 450–53. After examining the relationship of the conditions to the projected schedule and concluding that none of them made the schedule impossible, the court said that "[t]he securities laws do not make it unlawful for a company to publicize an aggressive time-

Thus, while the case was won largely by the careful caveats that the defendants included with their optimistic language in July 2013, it also benefited from favorable optics.

Section 12(a)(2) Elements and Defenses. Securities Act section 12(a)(2) provides a private cause of action for a purchaser of a security, against the seller of that security, where the sale occurs "by means of a prospectus or oral communication" that includes an "untrue statement of a material fact" or a statement that misleads by omission of a material fact.[593] A plaintiff's case must include proof that a defendant is a seller within the meaning of section 12, that the prospectus or other communication included a misrepresentation or misleading omission and that the plaintiff "did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission."[594] A prevailing plaintiff recovers "the consideration paid for [the] security with interest thereon, less the amount of any income received thereon, upon tender of [the] security," or, if the plaintiff no longer owns the security, "damages."[595] Under section 12(b), a defendant may reduce the damages by proving that "any portion or all of the amount recoverable . . . represents other than the depreciation in value of the subject security resulting from [the] part of the prospectus or oral communication, with respect to which the liability of that [defendant] is asserted."[596] A defendant may also prevail by proving either that (i) the defendant "did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission" or (ii) the plaintiff filed the action after the time permitted by Securities Act section 13.[597]

In 2017, the Second Circuit affirmed a judgment exceeding $806 million against Nomura Holding America, Inc. and affiliated entities ("Nomura") and RBS Securities, Inc. ("RBS"), after a bench trial of section 12(a)(2) and Blue Sky claims based

line or estimate for a proposed action without disclosing every conceivable stumbling block to realizing those plans." *Id.*

In the other case, the First Circuit held that plaintiffs failed to plead a Rule 10b-5 violation against a company that disclosed, before its initial public offering ("IPO"), two clotting events during a Phase II trial that were categorized as "serious," but did not disclose, until more than a year after the IPO when the death of a patient in a Phase III trial put that trial on hold, two other blood clotting events during the Phase II study that were categorized as "superficial." Brennan v. Zafgen, Inc., 853 F.3d 606, 609, 618 (1st Cir. 2017). The court of appeals noted that "the marginal materiality of the two superficial adverse thrombotic events undermines" "a strong inference of scienter." *Id.* at 616. Important too were FDA regulations that did not require a drug developer to "disclose every superficial adverse event until it" files a New Drug Application. *Id.* at 617. Moreover, since "[t]he defendants disclosed to investors the two serious adverse thrombotic events, and noted on several occasions that the company was not going to disclose all the adverse events as they occurred," "the totality of the company's disclosures produces a compelling counter-inference that the company wished to 'provide investors with warnings of risks,' actions[,] which 'generally weaken the inference of scienter.'" *Id.* at 617–18 (quoting City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Waters Corp., 632 F.3d 751, 760 (1st Cir. 2011) (quoting Ezra Charitable Tr. v. Tyco Int'l, Ltd., 466 F.3d 1, 8 (1st Cir. 2006))) (internal quotation marks omitted).

593. 15 U.S.C. § 77*l*(a)(2) (2012).

594. *Id.*; Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc., 873 F.3d 85, 98 (2d Cir. 2017), *petition for cert. filed*, No. 17-1300 & 17-1302 (U.S. Mar. 14, 2018).

595. 15 U.S.C. § 77*l*(a)(2).

596. *Id.* § 77*l*(b).

597. *Id.* § 77m.

on false representations in prospectus supplements ("ProSupps").[598] The plaintiffs rested their case on the charge that ProSupps for residential mortgage-backed securities ("RMBS", singular or plural, according to context) sold to the Federal Home Loan Mortgage Corporation ("Freddie") and the Federal National Mortgage Association ("Fannie") (collectively, the "GSEs") falsely represented that the loans underlying the RMBS (in each case called the supporting loan group or "SLG") had been originated "generally" in accord with applicable underwriting criteria.[599] The GSEs bought the RMBS during 2005 through 2007.[600] The Second Circuit decision ranges widely over the section 12(a)(2) elements and defenses.

Statutory seller. The Supreme Court held in *Pinter v. Dahl* that, to be properly sued under section 12, a defendant must be a "seller" within the meaning of that statute, and that a "statutory seller" must either have (i) passed title of the security to the plaintiff or (ii) successfully solicited the plaintiff to buy the security, with the defendant having been motivated to do so in order to further its own financial interests or those of the owner of the security.[601] Here, the defendants participated in a series of transactions that produced the RMBS that Fannie and Freddie bought—which began with lenders that originated home mortgages and passed through sponsors, depositors, trusts, and underwriters before coming to rest with the GSEs.[602] Two defendants of the Nomura entities had acted as depositors.[603] They contended that they were not "sellers" who could be liable under section 12 because they acted only as depositors.[604]

598. The defendants sold the RMBS through self-registrations, free writing prospectuses, and prospectus supplements. *Fed. Hous.*, 873 F.3d at 106, with the court using the term "ProSupps" to refer to prospectus supplements. *Id.* at 97. The bench trial, *id.*, yielded an award of "$806,023,457, comprised of roughly $555 million for violations of the Blue Sky laws and roughly $250 million for violations of the Securities Act," *id.* at 109.

599. *Fed. Hous.*, 873 F.3d at 97 (district court found that the ProSupps "falsely stated that "the loans supporting the [RMBS] were originated generally in accordance with the pertinent underwriting guidelines"); *id.* at 109 (while the lower court also found false statements regarding "loan-to-value ratio[s]" and "credit ratings," the court of appeals focused "solely [on] the statements regarding underwriting guidelines, which [were] sufficient to affirm the court's judgment"); *id.* at 98, 158 (affirming).

The guidelines assessed "the borrower's ability to repay and the value of the collateral." *Id.* at 101. The guidelines "generally permitted" originators to "make . . . exceptions to the underwriting criteria if there were compensating factors that indicated the borrower's ability and willingness to repay the loan." *Id.* at 101.

Fannie and Freddie purchased the RMBS at the end of a series of transactions: originators made mortgage loans, pooled them, sold them to sponsors, who sold them to depositors, who regrouped the loans into supporting loan groups ("SLGs") and transferred each SLG to a trust, in exchange for certificates, which the depositor sold on to underwriters, who sold the certificates (which were the RMBS) on to ultimate purchasers like Fannie and Freddie. *Id.* at 101–03. Nomura entities had acted as sponsors, and in some cases underwriters, for certificates that Fannie and Freddie bought, and a predecessor entity to the named RBS defendant had acted as an underwriter for some of the certificates. Fannie and Freddie also sued several individuals. *Id.* at 104 n.2. The district court awarded rescission-like relief against all defendants as either liable under Securities Act section 12(a)(2) or as control persons under section 15, 15 U.S.C. § 77o(a) (2012). *Id.* at 99–100.

600. *Id.* at 105, 162 app. D.

601. *Id.* at 139 (citing Pinter v. Dahl, 486 U.S. 622, 641–42 (1988)).

602. *See supra* note 599.

603. *Id.*

604. *Fed. Hous.*, 873 F.3d at 138–39.

Years after the *Pinter* decision, the SEC adopted Rule 159A, which includes an "issuer" among statutory sellers for section 12 purposes, and Rule 191, which states that, in asset-backed securities transactions, a "depositor to the issuing entity is the 'issuer'" of those securities.[605] The defendant depositors contended that those rules were invalid.[606] The Second Circuit disagreed, holding that it should defer to the SEC under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council* because both requirements for *Chevron* deference were met: (i) the rules construed a statute that was ambiguous and (ii) the interpretations in the rules were reasonable.[607] While the defendants contended that the *Pinter* decision "unambiguously foreclose[d]" the two rules, the Second Circuit read *Pinter* as finding "that the Securities Act is *ambiguous* as to the definition of statutory seller" because the Court held the term to include more than passing title sellers and said that the "statutory term[] '[is] expansive enough' for Section 12 'to encompass the entire selling process.'"[608] The SEC rules including depositors as sellers were reasonable because they "locate[d] depositors within [that] selling process."[609]

Falsity. The contested statement in each of the ProSupps read: "The Mortgage Loans [the payments on which would finance the payments to Fannie and Freddie on the RMBS] have been purchased by the seller [of the RMBS] from various banks, savings and loan associations, mortgage bankers and other mortgage loan originators and purchasers of mortgage loans in the secondary market, and were originated generally in accordance with the underwriting criteria described in this section."[610] The GSEs' expert re-underwrote 723 sample loans from those underlying the RMBS at issue, and found "that approximately 66% of the sample loans contained material deviations from the originators' underwriting criteria that negatively affected the creditworthiness of the loans."[611] While the district court "ultimately credited the bulk of [that expert's] analysis," it "conducted its own loan-by-loan underwriting analysis [which] confirmed that, as a 'conservative' measurement, at least 45% of the loans in each SLG 'had underwriting defects that materially affected credit risk.'"[612] The Second Circuit found "no basis to second guess" the lower court's adoption of a portion of the GSEs' expert analysis and no error in the lower court's own re-underwriting effort, for, as the trier of fact, the district court was "not required to make a binary choice between adopting an expert's conclusion in full or rejecting it entirely."[613]

605. *Id.* (citing and quoting 17 C.F.R. § 230.159A(a)); *id.* § 230.191(a). The SEC adopted Rule 191 in 2004. U.S. Sec. & Exch. Comm'n, Asset-Backed Securities, 70 Fed. Reg. 1506, 1631 (Jan. 7, 2005). The SEC adopted Rule 159A in 2005. U.S. Sec. & Exch. Comm'n, Securities Offering Reform, 70 Fed. Reg. 44722, 44831 (Aug. 3, 2005). The Supreme Court decided *Pinter* in 1988. *See supra* note 601.

606. *Fed. Hous.*, 873 F.3d at 139.

607. *Id.* (citing Chevron, U.S.A. v. Nat'l. Res. Def. Council, 467 U.S. 837 (1984)).

608. *Id.* at 139, 40 (quoting *Pinter*, 486 U.S. at 643) (emphasis added by the court).

609. *Id.* at 140; see *supra* note 599 for the depositor role in the chain of transactions here.

610. *Id.* at 140–41(emphasis omitted).

611. *Id.* at 143.

612. *Id.* at 143 (quoting Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc., 104 F. Supp. 3d 441, 533 (S.D.N.Y. 2015)).

613. *Id.* at 146.

The defendants contended, however, that the lower court's findings missed the point because the district court misinterpreted "'generally' to warn only that the [SLG for an RMBS] may contain loans with 'certain *immaterial* exceptions' to the underwriting guidelines."[614] The defendants contended that the representation instead "put readers . . . on notice that loans . . . may deviate materially from the underwriting guidelines."[615] The Second Circuit rejected this view because it "would render the underwriting guidelines statement essentially meaningless."[616]

As to one RMBS, defendants made the special argument against falsity that the ProSupp specifically warned that the "weak financial condition" of an originator supplying about 78 percent of the loans underlying that security might have "adversely affected its ability to originate mortgage loans in accordance with its customary standards" and that "this specific hedge superseded the more general statements about the quality of the supporting loans writ large."[617] The Second Circuit, however, found this warning "insufficient to put the reader on notice that a critical mass—nearly 50%—of the loans in the pertinent SLG were not originated properly."[618]

Materiality. The defendants contended that the representation in the ProSupps could not have been material because GSEs did not receive those supplements until after the trade dates for the RMBS.[619] But the Second Circuit found that sale of an RMBS—through shelf registrations, free writing prospectuses ("FWPs") containing "some (but not all) of the information regarding the loans" underlying a particular RMBS, followed by the ProSupp after a buyer committed to a purchase (on the "trade date")—was a "fluid process" by which the buyer's commitment was "[c]onditional" on the ProSupp revealing no "'new or changed information' that differed materially from the loan descriptions in the [FWP]."[620] Since the ProSupps therefore served the "dual functions of filling informational gaps left by the [FWP] offerings while also confirming that the loan quality representations in those initial offering documents were truthful in all material respects," they "assumed the material role of convincing [Fannie and Freddie] to finalize the transactions."[621]

In a second attack on materiality, the defense contended that Fannie and Freddie bought the RMBS "to meet a statutorily-mandated goal of devoting a percentage of their loan portfolio to low- and moderate-income housing, not to secure a return on investment" and that the agencies "knew that mortgage loans issued to borrowers with lower income came with an increased risk of default."[622] Rejecting the notion that this rendered the compliance-with-underwriting-criteria representation immaterial, the court of appeals reasoned that the test for materiality is an objective one—whether the misrepresented fact would have been significant to a "reasonable investor"—and that there was "no support" for adjusting

614. *Id.* at 145 (quoting *FHFA*, 104 F. Supp. 3d at 563) (emphasis added by the Second Circuit).
615. *Id.* at 144–45.
616. *Id.* at 145.
617. *Id.* at 142, 145.
618. *Id.* at 145.
619. *Id.* at 148.
620. *Id.* at 149.
621. *Id.* at 149–50.
622. *Id.* at 150–51.

that standard for "subjective facts about *the buyers* and their motives for engaging in the transaction."[623] The Second Circuit added that, even if that were not the case, Fannie and Freddie's "interest in whether the loans backing a particular [RMBS] met HUD's definition of low- and moderate-income housing [did] not exist to the exclusion of a profit motive," and the agencies evidenced their concern for loan quality by seeking "credit protection"[624] in part through the purchase of senior-tranche RMBS that would receive promised payments until so many of the underlying loans defaulted that lower-tranche RMBS received none.

Reasonable care defense. The trial court granted summary judgment to the GSEs on the defendants' statutory defense that they "did not know, and in the exercise of reasonable care could not have known," that the underwriting guideline representation was false.[625] Since Nomura acted as "sponsor, depositor, and occasional underwriter" for the RMBS, Nomura was "given access to the loans—and loan files—prior to purchase" of the underlying loans and was therefore "uniquely positioned . . . to know more than anyone else about the creditworthiness and underwriting quality of the loans."[626] But Nomura limited its diligence of the loan pools it bought for securitization to one round of review before purchasing a pool, with those reviews limited to samples of loans displaying credit risk (e.g., because of a high loan-to-value or debt-to-income ratio); and there was "no evidence whatever to suggest that [these characteristics were] indicators of the likelihood that a loan met the underwriting criteria."[627] A third-party vendor Nomura retained then reviewed "the sample loan files to re-underwrite the loans according to the originators' underwriting guidelines, additional criteria provided by Nomura, and applicable laws,"[628] rating each loan on a scale from 1 to 3, with "1 indicating that the loan met all the review criteria and 3 . . . that the loan materially deviated from the criteria or lacked critical documentation."[629] An audit of this process, however, found that 36 out of 109 loans scored by the vendor at 1 or 2 should have been scored 3.[630] Moreover, even this unsatisfactory review showed that the pools Nomura was buying and that were relevant to this case included 15.2 percent of 3s, nearly double the normal 7 percent to 8 percent.[631] Finally, once the loans from the pools were disaggregated, then reaggregated to form the SLGs to underlie a particular RMBS, Nomura "performed no review" on the reaggregated loans so that "Nomura had no way to know the credit risk of any given SLG."[632]

623. *Id.* at 151.

624. *Id.* at 151–52; *id.* at 96–97, 103 (explaining tranche protection); *id.* at 105 (stating that each RMBS purchased "is in a senior tranche of its respective Securitization").

625. *Id.* at 124 (quoting 15 U.S.C. § 77*l*(a)).

626. *Id.* at 132.

627. *Id.* at 132 (quotation), 125–26 (describing review of loans in "trade pools" purchased from originators, before regrouping loans differently for individual RMBS).

628. *Id.* at 126.

629. *Id.* at 126–27.

630. *Id.* at 127.

631. *Id.* at 127, 133.

632. *Id.* at 133.

RBS, the lead or co-lead underwriter for four of the seven RMBS at issue,[633] conducted "no independent review" of the loans underlying two of the four.[634] RBS used a third party to review a sample of the loans for each of the other two, but when (using a 1 to 3 numerical system like Nomura) the reviewer graded 30 percent of the sample as 3s for one of the RMBS and 16.2 percent of the sample as 3s for the other, RBS simply overrode "those grades and ordered that the loans be reclassified as acceptable."[635] RBS "provided no objective record evidence to support these overrides."[636]

Finding that Nomura's conduct "fell below the standard . . . [s]ection 12 requires"[637] and that "RBS's conduct was no better,"[638] the Second Circuit also had "no doubt that, had they exercised reasonable care, Defendants could have learned that a material number of the loans were not originated in accordance with the underwriting guidelines."[639] It therefore affirmed the summary judgment denying the reasonable care defense, agreeing with the district court's conclusion that this was the "'exceptional' case" in which this "mixed-law-and-fact question" could be so determined.[640]

Loss causation defense. The district court subtracted nothing from the computed loss based on the defense argument presented through two experts, who each "opined that the *entirety* of the [RMBS] losses were attributable to macroeconomic factors related to the 2008 financial crisis and not attributable to the . . . misrepresentations."[641] While the trial "court agreed that the financial crisis played a role in the [RMBS] reductions in value," it "concluded that Defendants," who had the burden of proof on loss causation, "failed to disaggregate the crisis from the . . . misstatements."[642] Interpreting section 12(b) as requiring a defendant to prove loss from a cause that is not related to the misrepresentations, the Second Circuit agreed and found "[t]he crucial point that doomed Defendants' loss causation defense is that those macroeconomic forces and the ProSupps' misstatements *were intimately intertwined*,"[643] because, as the lower court found, the "'shoddy [mortgage-loan] origination practices' of the sort concealed by the ProSupps' misstatements 'contributed to the housing bubble' that created the 2008 financial crisis."[644]

Statute of limitations. Section 13 provides that a plaintiff must bring a section 12(a)(2) claim "within one year after the discovery of the untrue statement

633. *Id*. at 127, 104 n.2; *see also supra* note 599.
634. *Id*. at 127.
635. *Id*. at 128–29.
636. *Id*. at 129.
637. *Id*. at 132.
638. *Id*. at 133.
639. *Id*. at 134.
640. *Id*. at 125.
641. *Id*. at 153.
642. *Id*.
643. *Id*. at 155.
644. *Id*. at 154 (quoting Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc., 104 F. Supp. 3d 441, 587 (S.D.N.Y. 2015)). The court also rejected the argument that the loss causation defense changed the section 12(a)(2) rescission remedy into a legal one, for which the defendants could obtain a jury trial. *Id*. at 135–37.

or the omission, or after such discovery should have been made by the exercise of reasonable diligence."[645] Congress extended the filing period for Fannie and Freddie contract claims to six years beyond the date that the Federal Housing Finance Agency ("FHFA") became the GSEs' conservator.[646] But the extension only applied to "contract claims that were valid on (or became valid after) September 6, 2008, the date on which FHFA assumed conservatorship."[647] The defendants asserted that the section 12(a)(2) claim failed because the one-year limitation period had run before September 6, 2008, since Fannie and Freddie "were or should have been aware that the . . . underwriting guidelines [representations] were false" by September 6, 2007.[648] The trial court granted the plaintiffs' motion for summary judgment on this defense, and the Second Circuit affirmed.[649]

The defendants contended that two circumstances should have alerted the agencies to their section 12(a)(2) claims more than one year before the conservatorships. First, Fannie and Freddie "conducted . . . reviews of originators with whom [the agencies] regularly did business" and reviews of originators of varying percentages of the loans underlying the RMBS here included critical comments and ratings.[650] The GSEs therefore "clearly knew or should have known that some originators who issued loans backing the [RMBS] were, as a general matter, less-than-rigorous in adhering to underwriting guidelines."[651] But, the Second Circuit reasoned, "they reasonably believed that not every loan issued by those originators was defective, that the SLGs backing the [RMBS the agencies bought] did not contain all of the originators' loans, and that the SLGs were not representative samples of the originators' entire loan pools."[652] Since the particular loans in the SLGs were selected by Nomura and RBS, "[a] reasonable investor's suspicions would be raised only if [those] Defendants' *loan selection processes* were also defective such that the shoddily underwritten loans would slip by their screens and into the SLGs" supporting the RMBS Fannie and Freddie bought.[653] Since both Nomura and RBS were—after reviews by the GSEs—on the GSEs' list of approved RMBS sellers,[654] "there was little indication" that the defendants' loan selection processes were wanting in that way.[655] Instead, the GSEs reasonably relied on the defendants' representations that the loans selected for the SLGs were, with immaterial exceptions, ones as to which the originators *had* followed underwriting criteria.[656]

645. 15 U.S.C. § 77m (2012).
646. 12 U.S.C. § 4617(b)(12)(A)(i)(I), (b)(12)(B)(i) (2012).
647. *Fed. Hous.*, 873 F.3d at 115.
648. *Id.* at 115, 120.
649. *Id.* at 115–16, 158.
650. *Id.* at 116–17.
651. *Id.* at 120.
652. *Id.*
653. *Id.*
654. *Id.* at 117.
655. *Id.* at 120–21. The court also noted that, to the extent that reviews of originators generated loan-level information, the agencies shielded such information from their traders out of concern for insider trading restrictions. *Id.* at 117.
656. *Id.* at 118, 121.

Fannie and Freddie had purchased senior tranches in the RMBS in which they invested, and the second circumstance that the defense argued to have put the agencies on notice of their section 12(a)(2) claims before September 6, 2007 was that credit rating agencies—in July 2007—lowered the credit rating on junior tranches in those very RMBS.[657] The Second Circuit found, however, that a decline in ratings for lower tranches—while the credit ratings on the higher tranches that the GSEs had bought were maintained—might cause "a reasonable senior [tranche investor to] understand . . . that any misrepresentation in the offering documents was mild enough that the subordination . . . still insulated them from loss."[658] Moreover, in order to make out the statute of limitations defense, Nomura and RBS needed to show not only that the downgrades should have raised the agencies' suspicions but also prompted "a reasonable investor" to "have conducted a fulsome investigation and uncovered information sufficient to make out a plausible claim for relief by September 6, 2007—just weeks after the credit downgrades."[659] The defendants offered no proof whatever "to establish this indispensable piece of the statute of limitations defense."[660]

Miscellaneous Cases. The Third Circuit determined that an investor plaintiff had not purchased an "investment contract" and therefore had not purchased a "security" where the agreement into which the plaintiff entered required the plaintiff to market the counterparty's proprietary software and assist the counterparty with the setup and maintenance of its geospatial information system.[661] The Ninth Circuit held that an issuer's statements about its success against a competitor were not false or misleading for failure to disclose details about the competitor's operations, given that the issuer warned repeatedly of competition, named the competitor in such warnings, and provided such specifics as that the competitor was attempting to counter the issuer's technological superiority by bundling strategies.[662] That same court held that a corporate code of conduct was aspirational so that statements touting a company's ethical conduct could not have been objectively false, for securities law purposes, even if, as the plaintiff alleged, the CEO was pursuing a questionable relationship with a contractor and falsifying business records to conceal the nature of that relationship; and the

657. *Id.* at 118.

658. *Id.* at 121–22.

659. *Id.* (citing Merck & Co. v. Reynolds, 559 U.S. 633 (2010)); *id.* at 119 (explaining that *Merck* changed the Second Circuit rule so that storm warnings placing a plaintiff on notice of a possible claim do not start the limitations period, which only begins "when, in the course of [a further investigation], the reasonable plaintiff would have discovered sufficient information to plead a securities-law violation adequately").

660. *Id.* at 122. The Second Circuit used the reasoning behind its statute of limitations analysis to affirm the lower court's summary judgment in favor of Fannie and Freddie on the necessary element that they did not know that the underwriting guideline representation was materially false when they bought the RMBS. *Id.* at 108, 122–24, 158.

661. Ne. Rev. Servs., LLC v. Maps Indeed, Inc., 685 F. App'x 96, 99–101 (3d Cir. 2017).

662. Par Inv. Partners, L.P. v. Aruba Networks, Inc., 681 F. App'x 618, 619–20 (9th Cir. 2017).

statements about the company's code were not material and did not create a duty to disclose the CEO's conduct.[663]

In a case involving violations of Exchange Act section 13, the Fifth Circuit held that, if misconduct requires the issuer to restate, the CEO and CFO are subject to a SOX section 304 clawback, even if there is another reason for the restatement as well.[664] The Eighth Circuit held that an investor in a fund of funds ("FOF") had no standing to make a claim under section 36(b) of the Investment Company Act to sue the investment adviser to the funds in which the FOF put money (which was also the adviser to the FOF) on the theory that excessive fees paid by those underlying funds to the adviser reduced the value of the investor's interest in the FOF.[665] The Eighth Circuit found no "finder exception" to the broker registration requirement, ruling instead that a multi-factor test should be employed to determine whether someone claiming to be a "finder" falls within the statutory definition of a "broker."[666] The Second Circuit affirmed dismissal of a complaint seeking section 16 short-swing profits recovery of a shareholder's alleged discount on the price of purchasing call options with paired sales of put options, where the shareholder had paid the issuer the premiums received from selling the call options.[667]

The Ninth Circuit held that a dismissal under the Securities Litigation Uniform Standards Act ("SLUSA") is a dismissal for want of jurisdiction and therefore should not be with prejudice.[668] The Seventh Circuit affirmed SLUSA dismissals of state law claims that (i) a bank provided financial incentives for employees to invest customer money in funds organized by the bank[669] and (ii) a bank received payments from mutual funds for investing in those funds excess cash in custodial accounts[670]—holding in both cases that the banks' failures to disclose the practices were "omissions" for purposes of finding the "omission or misrepresentation" necessary in order that SLUSA apply.[671]

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663. Retail Wholesale & Dep't Store Union Local 338 Ret. Fund v. Hewlett-Packard Co., 845 F.3d 1268, 1276–78 (9th Cir. 2017).

664. SEC v. Life Partners Holdings, Inc., 854 F.3d 765, 786–89 (5th Cir. 2017).

665. Am. Chems. & Equip. Inc. 401(K) Ret. Plan v. Principal Mgmt. Corp., 864 F.3d 859, 861, 863–65 (8th Cir. 2017).

666. SEC v. Collyard, 861 F.3d 760, 765–68 (8th Cir. 2017).

667. Olagues v. Icahn, 866 F.3d 70 (2d Cir. 2017).

668. Hampton v. Pac. Inv. Mgmt. Co., 869 F.3d 844 (9th Cir. 2017).

669. Holtz v. JPMorgan Chase Bank, N.A., Goldberg v. Bank of Am., N.A., 846 F.3d 928 (7th Cir. 2017), *cert. denied*, 138 S. Ct. 170 (2017) (No. 16-1536).

670. 846 F.3d 913 (7th Cir. 2017), *cert. denied,* 138 S. Ct. 173 (2017) (No. 16-1541).

671. 15 U.S.C. § 77p(b)(1) (2012); *id.* § 78bb(f)(1)(A).