Annual Review of Federal Securities Regulation

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

Contents

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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 2014. 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 2014, the U.S. Securities and Exchange Commission (the "Commission") continued to devote its resources to rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Substantial time was devoted to actions necessary to implement the requirements of Title VII of the Dodd-Frank Act to regulate the markets for security-based swaps. As required by the Dodd-Frank Act, the Commission proposed and adopted rules to eliminate certain references to credit ratings in existing rules. In August 2014, the Commission adopted rules under the Dodd-Frank Act that impose new governance and compliance requirements for nationally recognized statistical rating organizations ("NRSROs"). The requirements address internal controls, conflicts of interest, measures, including mandated disclosures, intended to promote transparency, and mandatory training and education for credit rating analysts. The rules also impose an annual certification requirement by the chief executive officer of the NRSRO regarding the effectiveness of the organization's internal controls. Also in August 2014, the Commission adopted amendments to Regulation AB, referred to as Regulation ABII, relating to offerings of asset-backed securities. The amendments to Regulation ABII also implement certain provisions of the Dodd-Frank Act. In October 2014, the Commission, together with the banking agencies, adopted final rules imposing a risk retention requirement on sponsors of securitization transactions.

During 2014, the Commission focused on rulemaking required of it by the Jumpstart Our Business Startups Act, or JOBS Act, which was enacted in April 2012.[2] For example, the Commission proposed amendments to revise the rules related to the thresholds for registration, termination of registration, and suspension of reporting under section 12(g) of the Securities Exchange Act of 1934, as amended, as required by Title V of the JOBS Act.

Generally, the Review does not discuss proposed regulations or rules that are narrowly focused. For example, the Review does not address regulation of over-the-counter derivatives, hedge fund and other private fund related rulemaking, or rulemaking related to registered investment companies, registered investment advisers, 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.

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

Regulatory Developments 2014

A. NRSRO Rules

Pursuant to the Dodd-Frank Act, the U.S. Securities and Exchange Commission ("SEC" or "Commission") was required to complete additional rulemaking relating to compliance policies and procedures applicable to NRSROs to promote integrity and reliability of ratings, as well as greater transparency for market participants relating to the activities of NRSROs.

Below, we provide a brief overview of the most significant requirements.

1. Internal Control Structure

In section 932(a)(2)(B) of the Dodd-Frank Act, Congress amended section 15E(c) of the Exchange Act to require pursuant to section 15E(c)(3)(A) that an NRSRO establish, maintain, enforce, and document an effective internal control structure, taking into account the factors prescribed by the Commission.[1] The governance and compliance policies and procedures should be designed to provide effective internal controls for the NRSRO to ensure that the ratings process comports with applicable rules and regulations. The final rule added a new paragraph (d) to Rule 17g-8 that sets out the factors that an NRSRO should consider in the design and implementation of its governance and compliance policies and procedures.[2] For example, the rules require that an NRSRO consider controls reasonably designed to ensure, among other things, that new ratings methodologies or updates to methodologies are subject to an appropriate review process; there be public disclosure of a new methodology or an update to an existing methodology together with the opportunity for public comment; regular internal audits of ratings files are conducted; quantitative models are subject to evaluation and validation prior to use; measures are implemented to evaluate the performance of credit ratings; etc.[3] In addition, an NRSRO must ensure that it has appropriate resources to implement and operate the internal control structure, monitor and detect any deficiencies, and address such deficiencies in a timely manner.[4] The Commission also adopted various requirements under Rule 17g-2

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 932(a)(2)(B), 124 Stat. 1376, 1873 (2010) (codified as amended at 15 U.S.C. § 78o-7(c)(3)(A) (2012)) [hereinafter Dodd-Frank Act].

2. Nationally Recognized Statistical Rating Organizations, 79 Fed. Reg. 55078, 55268–69 (Sept. 15, 2014) (to be codified at 17 C.F.R. pts. 232, 240, 249 & 249b).

3. *Id.*

4. *Id.* at 55269.

to require documentation of, and retention of any records or reviews relating to, the internal control structure.[5]

2. Annual Report

Section 15E(c)(3)(B) of the Exchange Act provides that the Commission will prescribe rules mandating that an NRSRO prepare and file with the Commission an annual report on internal controls.[6] The final rule, adopted as an amendment to Rule 17g-3, requires that an NRSRO file a report with the Commission annually addressing the effectiveness of its internal control structure that includes an attestation of the NRSRO's chief executive officer.[7] The report would disclose any identified weakness in the internal control structure.[8] The existence of a material weakness would prevent management from concluding that the internal control structure was effective.[9] The first such report would cover the fiscal year that ends on or after January 1, 2015.[10]

3. Conflicts of Interest

Section 932(a)(4) of the Dodd-Frank Act added paragraph (3) to section 15E(h) of the Exchange Act, which provides that the Commission will issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the credit ratings analysis.[11] The Commission implemented this mandate by adding to Rule 17g-5 a prohibition on the participation in the ratings process or in the development or approval of ratings procedures or methodologies of any sales and marketing personnel or of any personnel influenced by sales and marketing considerations.[12]

4. Look-Back Review

The Dodd-Frank Act requires that an NRSRO conduct a "look-back" review to ascertain whether the prospect of future employment with an issuer or an underwriter may have influenced a credit analyst's assessment of a credit rating and, if such influence is found to have existed, then the NRSRO must revise the rating in accordance with the requirements of rules implemented by the Commission.[13]

5. *Id.* at 55263 (to be codified at 17 C.F.R. § 240.17g-3).
6. 15 U.S.C. § 78o-7(c)(3)(B)(i)–(iii) (2012).
7. Nationally Recognized Statistical Rating Organizations, 79 Fed. Reg. at 55263–64 (to be codified at 17 C.F.R. § 240.17g-3).
8. *Id.* at 55263 (to be codified at 17 C.F.R. § 240.17g-3).
9. *Id.*
10. *Id.*
11. Dodd-Frank Act, *supra* note 1, § 932(a)(4), 124 Stat. at 1874 (codified as amended at 15 U.S.C. § 78o-7(h)(3) (2012)).
12. Nationally Recognized Statistical Rating Organizations, 79 Fed. Reg. at 55264 (to be codified at 17 C.F.R. § 240.17g-5).
13. Dodd-Frank Act, *supra* note 1, § 932(a)(4), 124 Stat. at 1875 (codified as amended at 15 U.S.C. § 78o-7(h)(4) (2012)).

The Commission adopted Rule 17g-8, which sets forth certain requirements for an NRSRO's look-back review policies and procedures.[14]

5. Clarification of Third-Party Due Diligence Provider

Rule 15Ga-2 of the Exchange Act requires that any issuer or underwriter of ABS securities that are rated by an NRSRO, whether offered pursuant to a registration statement or in an exempt offering other than an offering effected by a foreign (non-U.S. domiciled) issuer only to non-U.S. persons, furnish a form on EDGAR (Form ABS-15G) describing the conclusions of any third-party due diligence report obtained by the issuer or the underwriter.[15] The required Form ABS-15G must be filed at least five business days prior to the first sale of ABS securities in connection with the initial rating.[16]

Pursuant to Rule 17g-10(d)(1), a third-party due diligence report is understood to be a report regarding a review of the pool assets undertaken for the purpose of confirming the accuracy of the data regarding the pool assets, the conformance of the origination of the assets with the stated underwriting standards, the asset value, compliance by the originator of the assets with applicable laws, and any similar matters relating to the assets that would be material to the likelihood of the issuer of the ABS meeting its payment obligations.[17] A third-party due diligence provider must deliver a certification, in the form set out in the rule, to each NRSRO that is rating the related ABS securities.[18]

Pursuant to Rules 17g-7 and 17g-10, a third-party due diligence provider must provide a written certification using Form ABS Due Diligence-15E to each NRSRO that is providing a rating for the related ABS.[19] The issuer or underwriter that is obtaining the rating must promptly post the certification on the Rule 17g-5 website so that all NRSROs that may be retained to rate the ABS may access the certification.[20]

14. Nationally Recognized Statistical Rating Organizations, 79 Fed. Reg. at 55268 (to be codified at 17 C.F.R. § 240.17g-8).

15. *Id.* at 55261 (to be codified at 17 C.F.R. § 240.Ga-2).

16. *Id.*

17. *Id.* at 55270 (to be codified at 17 C.F.R. § 240.17g-10).

18. *Id.*

19. *Id.* at 55266, 55270 (to be codified at 17 C.F.R. §§ 240.17g-7, 240.17g-10). This Review uses the term "Item 1101 asset-backed securities" (or, unless the context requires otherwise, simply "asset-backed securities") to refer to securities defined as asset-backed securities in Item 1101(c) of Regulation AB under the Securities Act. *See* 17 C.F.R. § 229.1101(c) (2014). As used in this Review, the acronym "ABS" is generally intended to denote the broader meaning of "asset-backed securities" as that term is commonly used by securitization practitioners.

20. Nationally Recognized Statistical Rating Organizations, 79 Fed. Reg. at 55266 (to be codified at 17 C.F.R. § 240.17g-7).

B. Reg. AB Amendments

1. Overview

On September 4, 2014, the Commission issued its long-awaited final release (the "Reg. AB Amendments Adopting Release")[21] adopting numerous amendments (the "Reg. AB Release Amendments") to the regulations affecting registered offerings of asset-backed securities.

Notably, subject to the transition period described in the following paragraph, the Reg. AB Release Amendments:

- Replace the investment-grade rating condition to shelf registration of asset-backed securities[22] with four new eligibility criteria, including, for each asset-backed securities offering, requirements that the related depositor's chief executive officer execute a certification with respect to the offering[23] and that the offering's transaction agreements provide for the appointment of a third-party asset representations reviewer.[24]
- Implement, for registered offerings of certain classes of asset-backed securities,[25] expanded disclosure and reporting requirements[26] entailing standardized data points with respect to the securitized assets.[27]
- Impose "speed bumps" in the shelf registration offering process, primarily by requiring that a preliminary prospectus be filed with the Commission at least three business days before the first sale of offered securities.[28]

The Reg. AB Release Amendments' effective date (the "Effective Date") was November 24, 2014.[29] The Reg. AB Amendments Adopting Release states that "[r]egistrants must comply with new rules, forms, and disclosures other than the asset-level disclosure requirements no later than November 23, 2015."[30] Registered offerings of asset-backed securities of the Asset-Level Data Classes "must comply with the asset-level disclosure requirements no later than November 23,

21. Asset-Backed Securities Disclosure and Registration, Securities Act Release No. 9638, 79 Fed. Reg. 57184 (Sept. 24, 2014) (to be codified at 17 C.F.R. pts. 229, 230, 232, 239, 240, 243 & 249) [hereinafter Reg. AB Amendments Adopting Release].

22. *Id.* at 57189 (to be codified at 17 C.F.R. § 239.45).

23. *Id.* (to be codified at 17 C.F.R. § 239.45(b)(1)(i)).

24. *Id.* at 57190 (to be codified at 17 C.F.R. § 239.45(b)(1)(ii)).

25. For example, this includes asset-backed securities with underlying assets that are residential mortgage loans, commercial mortgage loans, or automobile loans or leases; resecuritizations of those classes of asset-backed securities; and asset-backed securities whose underlying assets are debt securities (collectively, the "Asset-Level Data Classes"). 17 C.F.R. § 229.1100(a) (2014); *see also* Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57188.

26. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57188.

27. *Id.* (to be codified at 17 C.F.R. § 229.1111(h)).

28. *Id.* at 57189 (to be codified at 17 C.F.R. § 230.424(h)(1)).

29. *Id.* at 57184.

30. *Id.* at 57305. November 23, 2015, is sometimes referred to in this Review as the "2015 Compliance Date."

2016. Any Form 10-D or Form 10-K filed after November 23, 2015, must comply with the new rules and disclosures, except asset-level disclosures."[31]

The Commission's adoption of the Reg. AB Amendments completes a process begun in April 2010 with the issuance of a proposing release,[32] followed by a re-proposal in July 2011,[33] a re-opening of the comment period for certain proposals in February 2014,[34] and an extension in March 2014 of the comment period for the February 2014 release.[35] Several matters addressed by the Reg. AB Amendments Proposing Release—in particular, risk retention—were subsequently the subject of the Dodd-Frank Act and were eventually dealt with not in the Reg. AB Amendments Adopting Release, but in other regulations spawned by the Dodd-Frank Act.[36] As discussed below,[37] certain other regulatory changes proposed in the Reg. AB Amendments Proposing Release but not adopted in the Reg. AB Amendments Adopting Release (or in any intervening release) have been tabled by the Commission for consideration at a later date.

This Review will describe the more significant changes made by the Reg. AB Amendments to the regulatory scheme in effect immediately before the Effective Date.

2. New Forms SF-1 and SF-3

The Commission has adopted new Forms SF-1 and SF-3,[38] which will replace Forms S-1 and S-3, respectively, for the registration of Item 1101 asset-backed securities offerings.[39] Any such offerings that seek shelf registration and qualify for it must be registered on Form SF-3.[40] In other words, on and after the 2015 Compliance Date, "ABS issuers seeking to conduct a shelf ABS offering must conduct such offering off of an effective Form SF-3 registration statement."[41] Non-shelf

31. *Id.*
32. Asset-Backed Securities, Securities Act Release No. 9117, 75 Fed. Reg. 23328 (proposed May 3, 2010) (to be codified at 17 C.F.R. pts. 229, 230, 232, 239, 240, 243 & 249) [hereinafter Reg. AB Amendments Proposing Release].
33. Re-Proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment, Securities Act Release No. 9244, 76 Fed. Reg. 47948 (proposed Aug. 5, 2011) (to be codified at 17 C.F.R. pts. 229, 230, 239 & 249) [hereinafter 2011 Re-Proposing Release].
34. Re-Opening of Comment Period for Asset-Backed Securities Release, Securities Act Release No. 9552, 79 Fed. Reg. 11361 (Feb. 28, 2014).
35. Extension of Comment Period for Asset-Backed Securities Release, Securities Act Release No. 9568, 79 Fed. Reg. 18483 (Apr. 2, 2014).
36. *See, e.g.*, Credit Risk Retention, 79 Fed. Reg. 77602 (Dec. 24, 2014) (to be codified at 17 C.F.R. pt. 246); Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4511 (Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 229, 232, 240 & 249), *as amended by* Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 54375 (Sept. 1, 2011) (to be codified at 17 C.F.R. pt. 240).
37. *See* text accompanying *infra* notes 139–40.
38. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57265 (to be codified at 17 C.F.R. §§ 239.44, 239.45).
39. *Id.* at 57190.
40. *Id.* at 57265.
41. *Id.* at 57303.

offerings are to be registered on Form SF-1.[42] Form S-1 will still be available for the registration of offerings of ABS other than Item 1101 asset-backed securities.[43]

3. New Form SF-3 Shelf Registration Requirements

a. Form SF-3 Transaction Requirements

Currently, in order for an offering of Item 1101 asset-backed securities to be eligible for shelf registration on Form S-3, the offering must satisfy certain conditions of this form that are set forth under the caption "Transaction Requirements." One of those conditions is that the securities must be "investment grade securities," i.e., at the time of their sale, at least one NRSRO must have rated them "in one of its generic rating categories that signifies investment grade; typically, the four highest rating categories."[44] With the adoption of Form SF-3, the investment-grade-security condition will be replaced with the following four new eligibility criteria (the "SF-3 New Transaction Requirements")[45]:

(i) Certification of the Depositor's CEO

The registrant will be required to file a certification signed by the depositor's chief executive officer with respect to each offering of asset-backed securities registered on Form SF-3.[46] The certification, which must be dated as of the date of the final prospectus,[47] would be in a prescribed form[48] to the effect, among other matters, that the CEO had reviewed the prospectus and, that on the basis of his or her knowledge, there was

> a reasonable basis to conclude that the securitization is structured to produce, but is not guaranteed by this certification to produce, expected cash flows at times and in amounts to service scheduled payments of interest and the ultimate repayment of principal on the securities (or other scheduled or required distributions on the securities, however denominated) in accordance with their terms as described in the prospectus.[49]

The Reg. AB Amendments Adopting Release states that "requiring the chief executive officer to sign a certification at the time of each takedown will help to ensure that he or she is actively involved in the oversight of the transaction when the actual structuring occurs."[50]

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42. *Id.* at 57265.
43. *See* General Instructions to Form S-1 (referenced in Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57332).
44. *See* General Instructions to Form S-3 (referenced in Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57332–33); *see also* Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57259.
45. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57189 (to be codified at 17 C.F.R. § 239.45(b)(1)).
46. *Id.* at 57274 (to be codified at 17 C.F.R. § 239.45(b)(1)(i)).
47. *Id.*
48. *Id.* at 57312–13 (to be codified at 17 C.F.R. § 229.601(b)(36)).
49. *Id.* at 57313 (to be codified at 17 C.F.R. § 229.601(b)(36)).
50. *Id.* at 57267.

(ii) Asset Review Provision

The transaction agreements underlying an offering of asset-backed securities registered on Form SF-3 will be required to provide that, among other matters:

- A review of the transaction's underlying assets for compliance with the related representations and warranties will be triggered when, at a minimum, both of the following conditions (the "Review Triggers") are met: (i) delinquencies on the assets, as a percentage dollar amount, reach or exceed a threshold that is to be specified in the transaction agreements; and (ii) investors vote to direct the review, pursuant to processes specified in the transaction agreements, provided that (a) the total interest in the pool in order to initiate the vote may not be set at more than 5 percent and (b) the vote needed to direct the review may not be set at more than a simple majority of the interests casting a vote.[51]
- The review is to be conducted by an asset representations reviewer[52] that is selected and appointed in accordance with the transaction agreements but is neither (i) affiliated with any sponsor, depositor, servicer, or trustee of the transaction (or any of their affiliates) nor (ii) the same party or an affiliate of any party hired by the transaction's sponsor or the underwriter to perform pre-closing due diligence work on the pool assets.[53]
- The reviewer must not be the transaction party responsible for determining whether noncompliance with representations or warranties constitutes a breach of any provision of the transaction agreements.[54]
- When the Review Triggers are met, the reviewer must perform, at a minimum, reviews of all assets sixty days or more delinquent.[55]
- The reviewer is to provide the trustee with a report of the findings and conclusions of the review.[56]

The Reg. AB Amendments Adopting Release states that the asset review requirement, "coupled with the new dispute resolution and investor communication shelf requirements,[[57]] should provide investors with effective tools to address the enforceability of repurchase obligations and help overcome collective action problems."[58]

51. *Id.* at 57337 (to be codified at 17 C.F.R. § 239.45(b)(1)(ii)(C)).
52. *Id.* at 57313 (to be codified at 17 C.F.R. § 229.1101(m)).
53. *Id.* at 57337 (to be codified at 17 C.F.R. § 239.45(b)(1)(ii)(A), (C)).
54. *Id.* (to be codified at 17 C.F.R. § 239.45(b)(1)(ii)(C)).
55. *Id.* at 57338 (to be codified at 17 C.F.R. § 239.45(b)(1)(ii)(D)).
56. *Id.* (to be codified at 17 C.F.R. § 239.45(b)(1)(ii)(E)).
57. These are discussed in the two following subparts.
58. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57277.

(iii) Dispute Resolution Provision

The transaction agreements underlying an offering of asset-backed securities registered on Form SF-3 will be required to provide that if a securitized asset subject to a repurchase request made pursuant to the terms of the transaction agreements is not "resolved" by the end of a 180-day period beginning with receipt of notice of the request, the party submitting the request may, at its discretion, refer the matter to either mediation or third-party arbitration, and the party obligated to repurchase must agree to the selected resolution method.[59] If the requesting party elects third-party arbitration, the allocation of expenses will be determined by the arbitrator.[60] If, however, the requesting party elects mediation, the allocation of expenses will be mutually determined by the requesting party and the obligated party.[61]

The Reg. AB Amendments Adopting Release states that the dispute resolution requirement was intended to operate separately from any asset review and was "structured" to enable investors to use it "for any repurchase request, regardless of whether [the] investors direct a review of the assets."[62]

(iv) Investor Communication Provision

The transaction agreements underlying an offering of asset-backed securities registered on Form SF-3 must require Form 10-D filers to include in the Form 10-D report any request received during the reporting period from investors, including beneficial owners that are not record holders, to communicate with other investors as to the exercise of investor rights under the agreements' terms.[63]

The Commission believes that this requirement "will assist investors in exercising their rights related to the new asset review provision."[64]

b. Form SF-3 Registrant Requirements

Form SF-3 will require registrants to satisfy two eligibility conditions (the "SF-3 Registrant Requirements") set forth in the form under the caption "Registrant Requirements." One of them requires the depositor and certain related issuing entities to have made timely filings during a period of twelve calendar months and any portion of a month immediately before the Form SF-3 registration statement filing, to the extent that any of them were subject to Exchange Act reporting requirements with respect to asset-backed securities involving the same asset class during that period.[65] This SF-3 Registrant Requirement is substantially identical to one of the current registrant requirements of Form S-3.[66]

59. *Id.* at 57338 (to be codified at 17 C.F.R. § 239.45(b)(1)(iii)(A)).
60. *Id.* (to be codified at 17 C.F.R. § 239.45(b)(1)(iii)(B)).
61. *Id.*
62. *Id.* at 57282.
63. *Id.* at 57338 (to be codified at 17 C.F.R. § 239.45(b)(1)(iv)).
64. *Id.*
65. *Id.* at 57337 (to be codified at 17 C.F.R. § 239.45(a)(2)).
66. *Compare id.* at 57337 (to be codified at 17 C.F.R. § 239.45(a)(2)), *with id.* at 57332 (to be codified at 17 C.F.R. § 239.13(a)(4)).

Under the other Form SF-3 Registrant Requirement, the depositor and certain related issuing entities would have had to file on a timely basis all certifications and all transaction agreements containing the provisions required by the SF-3 New Transaction Requirements, to the extent that the depositor or any such issuing entity had been required to comply with those requirements for a previous offering of asset-backed securities of the same asset class during the period described in the preceding paragraph.[67]

The Form SF-3 registration statement will be required to disclose that the registrant has complied with the SF-3 Registrant Requirements.[68]

c. Annual Compliance Check

As amended by the Reg. AB Release Amendments, Rule 401 of the Securities Act will require a determination of whether a previously effective Form SF-3 registration statement complies with the SF-3 Registrant Requirements as of the date that is ninety days after the depositor's fiscal year-end.[69] Any lack of compliance under the circumstances discussed in the first paragraph under Form SF-3 Registrant Requirements above would render the registration statement unavailable for subsequent offerings "for at least one year from the date the depositor or the affiliated issuing entity that had failed to file Exchange Act reports then became current in [those] reports."[70] In the case of any compliance failure under the circumstances discussed in the second paragraph under Form SF-3 Registrant Requirements above, that registrant requirement would be deemed satisfied, for purposes of Form SF-3, ninety days after the date of filing the delinquent information.[71]

d. Preliminary Prospectus in Takedown Off Form SF-3 Registration Statement

New Rule 430D will replace current Rule 430B to the extent that Rule 430B governs shelf offerings of asset-backed securities.[72] Rule 430D, together with Rule 424(h), will allow the form of prospectus filed as part of a Form SF-3 registration statement to omit "information that is unknown or not reasonably available to the issuer"[73]—i.e., offering-specific information—provided that the issuer filed a preliminary prospectus (a "Rule 424(h) prospectus"), disclosing the previously omitted information (other than certain price-related information), at least three business days before the date of the first sale in the offering, or if used earlier, the earlier of (i) the applicable number of business days before the date of the first sale and (ii) the second business day after first use.[74] The

67. *Id.* at 57337 (to be codified at 17 C.F.R. § 239.45(a)(1)(i)–(ii)).
68. *Id.*
69. *Id.* at 57287.
70. *Id.*
71. *Id.* at 57288 (to be codified at 17 C.F.R. § 239.45(a)(1)(iii)).
72. *Id.* at 57264.
73. *Id.* at 57330 (to be codified at 17 C.F.R. § 230.430D(a)).
74. *Id.* at 57329 (to be codified at 17 C.F.R. § 230.424(h)(1)).

inclusion of omitted price-related information may be deferred until the filing of the final prospectus.[75]

Any material change from the information contained in the Rule 424(h) prospectus (other than price-related information) would need to be reflected in a prospectus supplement filed at least forty-eight hours before the first sale in the offering.[76] The prospectus supplement would have to "clearly delineate" what material information changed and how the information had changed from the Rule 424(h) prospectus.[77] Structural and/or credit-enhancement features may be added only by post-effective amendment and not by including the changes in a final prospectus filed under Rule 424(b).[78]

On and after the 2015 Compliance Date, shelf registration statements will no longer be permitted to include multiple forms of prospectuses.[79] Each Form SF-3 registration statement will be limited to a single form of prospectus corresponding to one asset class.[80] Furthermore, General Instruction IV of Form SF-3 will require an integrated form of prospectus for each offering; consequently, the base-and-supplement format widely used in the past will no longer be permitted.[81] The Commission believes that "[a] single form of prospectus at the time of effectiveness and a single prospectus for each takedown should provide investors with clearer and more focused information relating to the assets that are the subject of the takedown by not encumbering investors with information that may not relate to that particular transaction."[82]

e. 48-hour Preliminary Prospectus Delivery Requirement

Exchange Act Rule 15c2-8(b) has been amended to apply to each registered offering of asset-backed securities, whether the issuer is, or previously has been, subject to Exchange Act reporting obligations or is exempt from those obligations.[83] Consequently, at least forty-eight hours before a broker or dealer sends a confirmation of sale to any person who is expected to receive such a confirmation, the broker or dealer will be required to deliver to that person a copy of the preliminary prospectus.[84]

f. "Pay-as-You-Go" Registration Fees for Form SF-3

As amended, Rule 456 under the Securities Act will allow, but not require, asset-backed issuers that register offerings of asset-backed securities on Form SF-3 to defer payment of all or any part of their registration fees until the filing

75. *Id.* at 57330 (to be codified at 17 C.F.R. § 230.430D(d)(1)(ii)).
76. *Id.* at 57329 (to be codified at 17 C.F.R. § 230.424(h)(2)).
77. *Id.*
78. *Id.* at 57293 (to be codified at 17 C.F.R. § 230.430D(d)(2)).
79. *Id.* at 57292.
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.* at 57344 (to be codified at 17 C.F.R. § 240.15c2-8(b)).
84. *Id.* at 57290.

of the related Rule 424(h) prospectus.[85] Before adoption of the Reg. AB Release Amendments, only "well-known seasoned issuers" had that option in connection with automatic shelf registration statements.[86]

4. Expanded Disclosure Requirements

a. Asset-Level Data

On and after November 23, 2016, the Commission will require specific asset-level information, in a standardized format, in filed offering materials and post-offering periodic reports with respect to every asset in the pool of assets underlying a registered offering of Item 1101 asset-backed securities in the six Asset-Level Data Classes (but no other asset classes).[87]

New Item 1111(h) of Regulation AB requires the filing of asset-level information constituting an "Asset Data File"—technically, "machine-readable computer code that presents information in eXtensible Markup Language (XML) electronic format"[88]—as an exhibit to new Form ABS-EE.[89] The asset-level information constituting the Asset Data File is to be responsive to the specific data points set forth in new Schedule AL in new Item 1125.[90] Registrants will be permitted to provide, at their option, additional asset-level information (as well as additional explanatory disclosure) by filing "asset related documents" as additional exhibits to Form ABS-EE.[91]

Forms SF-1 and SF-3 require that the asset-level information filed as exhibits to Form ABS-EE be incorporated into the related prospectus.[92] For preliminary and final prospectuses, the Schedule AL data must be provided as of the end of the most recent reporting period, unless Schedule AL specifies otherwise.[93]

Form 10-D similarly requires that asset-level information filed as exhibits to Form ABS-EE (for the related reporting period) be incorporated into Form 10-D reports.[94] For ongoing reports, Schedule AL data must be provided as of the end of the reporting period covered by the Form 10-D, unless Schedule AL specifies otherwise.[95] An instruction to Item 1111(h) clarifies that all of the information required by Item 1111 must be provided at the time of every filing for every asset that was in the asset pool during the applicable reporting period, including assets removed before the end of the reporting period.[96]

85. *Id.* at 57331 (to be codified at 17 C.F.R. § 230.456(c)).
86. *See id.* (to be codified at 17 C.F.R. §§ 230.456(b), 230.457(r)).
87. *Id.* at 57188.
88. *Id.* at 57332 (to be codified at 17 C.F.R. § 232.11).
89. *Id.* at 57315, 57346 (to be codified at 17 C.F.R. § 229.1111(h)(1)–(3), 17 C.F.R. § 249.1401).
90. *Id.* at 57316 (to be codified at 17 C.F.R. § 229.1125).
91. *Id.* at 57315 (to be codified at 17 C.F.R. § 229.1111(h)(4), (5)).
92. Form SF-1 (referenced in Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57231); Form SF-3 (referenced in Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57231).
93. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57209 (to be codified at 17 C.F.R. § 229.1125).
94. Form 10-D (referenced in Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57231).
95. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57209 (to be codified at 17 C.F.R. § 229.1125).
96. *Id.* at 57315 (to be codified at 17 C.F.R. § 229.1111(h)).

The number and character of data points varies with each Asset-Level Data Class, ranging from 60 data points for asset-backed securities whose underlying assets are debt securities[97] to 270 data points for asset-backed securities whose underlying assets are residential mortgage loans.[98] The Reg. AB Amendments Adopting Release describes several general data point categories:

- Data points relating to an asset's payment stream.[99]
- Data points that allow for an analysis of collateral underlying an asset.[100]
- Data points that concern an asset's performance over time.[101]
- Data points about a servicer's loss mitigation efforts and about asset losses that may be borne by investors.[102]
- Data points about mortgage insurance coverage, lien position, and the extent to which income and employment status have been verified.[103]

The Commission apparently believes that asset-level information "will allow an investor to better conduct his or her own evaluation of the ongoing credit quality of a particular asset, risk layering of assets, and overall risks in the pool underlying the [asset-backed securities]."[104] As noted below under Proposed Rules Not Being Adopted at This Time, the Commission is continuing to consider whether and how to expand the new asset-level disclosure requirements.

b. Pool-Level Information

Item 1111 of Regulation AB requires certain information about the pool assets to be covered by the prospectus disclosure.[105] As amended by the Reg. AB Release Amendments, Item 1111 will now also require the following disclosure:

- A summary of representations and warranties made about the pool assets by the sponsor, transferor, originator, or other party to the transaction and a brief description of the remedies available (such as repurchase obligations) if those representations and warranties are breached.[106]
- A description of the provisions, if any, in the transaction agreements governing modification of the terms of any assets, including how such modifications might affect cash flows from the assets or to the securities.[107]

97. *Id.* at 57229.
98. *Id.* at 57210.
99. *Id.* at 57188.
100. *Id.*
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.* at 57315 (to be codified at 17 C.F.R. § 229.1111).
106. *Id.*
107. *Id.*

c. Static Pool Information

The Reg. AB Release Amendments include revisions to the static pool information disclosure requirements "to increase the clarity, transparency, and comparability of static pool information."[108] Introductory text has been added to Item 1105 to require (i) a narrative description of the static pool information presented; (ii) a graphical presentation of the information (if its addition would aid in understanding); (iii) appropriate introductory and explanatory information to introduce the pool characteristics, the methodology used in determining or calculating those characteristics, and the terms and abbreviations used; and (iv) a description of how the static pool assets differ from the pool of assets underlying the offered securities.[109] Graphical presentation of delinquency, losses, and prepayments for amortizing asset pools will now be required, pursuant to amended Item 1105(a)(3)(iv).[110]

Item 1105(a)(3)(ii) has been amended to require static pool information related to historical delinquencies and losses to be presented for amortizing asset pools in accordance with the guidelines outlined in Item 1100(b), i.e., in 30- or 31-day increments, as applicable, though not less than 120 days.[111] Item 1105(c) has been amended to require an issuer to explain any absence of static pool information and, if the issuer included disclosure intended to serve as alternative static pool information, to explain why.[112]

Form SF-3 contains an instruction that the static pool information required by Item 1105 of Regulation AB may be filed pursuant to new Item 6.06 of Form 8-K.[113] The information can then be incorporated by reference into the prospectus.[114]

d. Structure of the Transaction

Item 1113 of Regulation AB has been amended to require a description of how the delinquency threshold that triggers a review by the asset representations reviewer was determined to be appropriate and, as part of that description, a comparison of the delinquency threshold against the delinquencies disclosed in accordance with Item 1105 for prior securitized pools of the sponsor for the same asset type.[115]

e. Additional Disclosures with Respect to Transaction Parties

(i) Asset Representations Reviewer

Item 1109 of Regulation AB has been amended to require disclosure with respect to the asset representations reviewer, including (i) the extent of its prior

108. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57255.
109. *Id.* at 57314 (to be codified at 17 C.F.R. § 229.1105).
110. *Id.*
111. *Id.*
112. *Id.*
113. *See* Item 8 (captioned "Static Pool") of "Part I—Information Required in Prospectus" in Form SF-3 (referenced in Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57337).
114. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57258.
115. *Id.* at 57315 (to be codified at 17 C.F.R. § 229.1113(a)(7)(i)).

experience as a reviewer for asset-backed securities transactions involving similar pool assets, (ii) its duties and responsibilities regarding the asset-backed securities under the governing documents and under applicable law, (iii) the amount and manner in which it is to be compensated, (iv) any limitations on its liability under the related transaction agreements, (v) any contractual provisions that would entitle it to be indemnified from cash flow that would otherwise be paid to the securities' holders, and (vi) any contractual provisions or understandings regarding its removal, replacement, or resignation.[116]

(ii) Identification of Originators

Before the adoption of the Reg. AB Release Amendments, Regulation AB did not require an issuer to disclose the identity of any originator (other than the sponsor or its affiliates, if they were also originators) that had not originated, and was not expected to originate, 10 percent or more of the pool assets.[117] Item 1110(a), as amended, will now require disclosure of the identity of *each* originator, if the cumulative amount of assets originated by parties other than the sponsor or its affiliates exceeds 10 percent of the pool assets.[118]

(iii) Financial Information Regarding Parties Obligated to Repurchase

Items 1104 and 1110 have respectively been amended to provide that if the sponsor or, if applicable, an originator that has originated, or is expected to originate, 20 percent or more of the related assets (a "20 percent originator") is obligated under the transaction documents to repurchase or replace a pool asset for breach of a representation and warranty, information must be provided with respect to the obligated party's financial condition to the extent that the effect it might have on the obligated party's ability to comply with its repurchase obligations creates a material risk of a material impact on pool performance or on the performance of the asset-backed securities.[119]

(iv) Economic Interest in the Transaction

Amendments to Items 1104, 1108, and 1110 respectively require disclosure of any interest retained by the sponsor, any servicer, or any 20 percent originator (or any of their respective affiliates), including the amount and nature of the interest, as well as any security-specific or portfolio hedge entered into by the sponsor, any servicer, or any 20 percent originator, as applicable (or, if known, by any of their respective affiliates), to offset the risk position held, if the hedge is materially related to the securities' credit risk.[120] The disclosure must separately state the amount and nature of any interest or asset retained

116. *Id.* at 57314 (to be codified at 17 C.F.R. § 229.1109(b)).
117. *Id.* at 57250.
118. *Id.* at 57315 (to be codified at 17 C.F.R. § 229.1110(a)).
119. *Id.* at 57313 (to be codified at 17 C.F.R. §§ 229.1104(f), 229.1110(c)).
120. *Id.* at 57313–15 (to be codified at 17 C.F.R. §§ 229.1104(g), 229.1108(e) & 229.1110(b)(3)).

to comply with the risk retention requirements, including any amounts that are retained by parties other than the sponsor, any servicer, or any 20 percent originator, as applicable, in order to satisfy such requirements.[121]

f. Filing Requirements for Transaction Documents

Under Item 1100(f), as amended, final transaction agreements for each offering off a Form SF-3 registration statement will have to be filed and made part of the registration statement no later than the date on which the offering's final prospectus is required to be filed under Rule 424.[122]

g. Revisions to the Definition of "Asset-Backed Security"

Historically, only ABS that are Item 1101 asset-backed securities have been eligible for shelf registration.[123] An "asset-backed security" under Item 1101(c) of Regulation AB is a security that, in addition to satisfying certain other requirements, must be "primarily serviced by the cash flows of a discrete pool of receivables or other financial assets."[124] From the time of Regulation AB's adoption, the "discrete pool" requirement has been subject to certain exceptions, set forth in Item 1101(c)(3).[125] That item has been amended to limit one of those exceptions by reducing the maximum amount of prefunding for the future acquisition of additional assets from 50 percent of the proceeds of the related securities offering (or, in the case of master trusts, 50 percent of the aggregate principal balance of the total asset pool the cash flows of which support the asset-backed securities) to 25 percent.[126]

5. Effect of Reg. AB Release Amendments on Exchange Act Reporting

a. Form 10-D

The Reg. AB Release Amendments amended Form 10-D and made several additions to Item 1121 of Regulation AB. The new information called for by the Item 1121 additions must be set forth in all Form 10-D reports filed after the 2015 Compliance Date.[127]

121. *Id.*
122. *Id.* at 57313 (to be codified at 17 C.F.R. § 229.1100(f)).
123. *See* General Instruction I.B.5 to Form S-3 (referenced in Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57332).
124. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57313 (to be codified at 17 C.F.R. § 229.1101(c)).
125. *Id.* at 57296.
126. *Id.* at 57313 (to be codified at 17 C.F.R. § 229.1101(c)(3)(ii)).
127. *See* Item 1 of "Part I—Distribution Information" in Form 10-D (referenced in Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57305).

- Item 1121(a)(9) requires historical delinquency and loss information for the related distribution period to be presented in 30- or 31-day increments, as applicable, for a period of not less than 120 days.[128]
- Item 1121(d)(1) requires (i) a description of the event(s) that triggered an asset review performed during the distribution period and (ii) if, during the distribution period, the asset representations reviewer provided the trustee with a report of the findings and conclusions of the review, a summary of that report.[129]
- Item 1121(d)(2) requires (i) a statement of the date on which, during the distribution period, an asset representations reviewer resigned; was removed, replaced or substituted; or was appointed; in each case together with a statement of the circumstances surrounding the change; and (ii) if a new asset representations reviewer was appointed, the disclosure required by Item 1109(b) (discussed above) with respect to that reviewer.[130]
- Item 1121(e) requires disclosure of each request, if any, received from an investor to communicate with other investors during the related reporting period, if the request was received by the Form 10-D filing party on or before the end date of a distribution period.[131] The Form 10-D filer is required to disclose an investor's request to communicate only where the communication relates to exercise of the investor's rights under the terms of the transaction agreements.[132]

One of the Form 10-D amendments calls for that report to set forth the information required by new Item 1124 regarding material changes, if any, in the sponsor's or an affiliate's interest in the securities resulting from the purchase, sale, or other acquisition or disposition of the securities by the sponsor or an affiliate during the period covered by the Form 10-D report.[133]

b. Form 10-K: Servicer's Assessment of Compliance with Servicing Criteria

Item 1122 of Regulation AB has historically required an asset-backed securities issuer's Form 10-K report to contain an assessment of compliance with servicing criteria by each party participating in the servicing function and to disclose, among other things, material instances of noncompliance with Item 1122 servicing criteria.[134] The servicer's assessment is required to be made at the servicing platform level rather than with respect to specific asset pools, and a particular servicer

128. Reg. AB Amendments Adopting Release, 79 Fed. Reg. at 57315 (to be codified at 17 C.F.R. § 229.1121(a)(9)).
129. *Id.* (to be codified at 17 C.F.R. § 229.1121(d)(1)).
130. *Id.* (to be codified at 17 C.F.R. § 229.1121(d)(2)).
131. *Id.* at 57316 (to be codified at 17 C.F.R. § 229.1121(e)).
132. *Id.*
133. *Id.* (to be codified at 17 C.F.R. § 229.1124).
134. *Id.* (to be codified at 17 C.F.R. § 229.1122(c)).

may provide servicing for several unaffiliated issuers.[135] Consequently, before the adoption of the Reg. AB Release Amendments, "it may not [have been] clear whether the asset-backed securities covered in the Form 10-K report may have been impacted by the material instance of non-compliance."[136] To address this concern, the Commission has amended Item 1122 to require disclosure of whether any identified material instances of noncompliance were determined to have involved the servicing of the assets underlying the asset-backed securities covered in the Form 10-K report.[137] Item 1122 has been further amended to require a discussion of the steps taken, if any, to remedy any material instances of noncompliance previously identified by the servicing function participant for its platform-level activities.[138]

6. Proposed Rules Not Being Adopted at This Time

The Commission has taken no action on a number of rule changes proposed in the Reg. AB Amendments Proposing Release or the 2011 Re-Proposing Release. The Reg. AB Amendments Adopting Release refers to seven of them.[139]

- Subjecting Rule 144A offerings to the expanded disclosure rules adopted by the Reg. AB Release Amendments for registered offerings.
- Applying the asset-level disclosure requirements to asset-backed securities other than the Asset-Level Disclosure Classes.
- Requiring group-account disclosure for asset-backed securities the underlying assets of which are credit card and charge card receivables.
- Requiring issuers to file with the Commission electronically a "waterfall" computer program with downloadable source code that models contractual cash flow provisions of the asset-backed securities.
- Requiring that transaction documents, in substantially final form, be filed by the date of the required filing of the preliminary prospectus (rather than the final prospectus).
- Exempting issuers of asset-backed securities from existing requirements that the principal accounting officer or controller of the depositor sign the registration statement and, instead, requiring that the registration statement be signed by an executive officer in charge of securitization.
- Revising when an issuer must update pool disclosure on Form 8-K.

The Reg. AB Amendments Adopting Release states that these proposals "remain outstanding."[140]

135. *Id.*
136. *Id.* at 23391.
137. *Id.* at 57316 (to be codified at 17 C.F.R. § 229.1122(c)(1)).
138. *Id.* (to be codified at 17 C.F.R. § 229.1122(c)(2)).
139. *Id.* at 57190–91.
140. *Id.* at 57190.

C. Credit Risk Retention Rules

1. Overview

On October 21 and 22, 2014, the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency, the Federal Reserve Board, the Commission, the Federal Housing Finance Agency (the "FHFA"), and the Department of Housing and Urban Development (collectively, the "Joint Regulators") each adopted a final rule (the "Final Rule") implementing the credit risk retention requirements of section 941 of the Dodd-Frank Act for ABS.[141] The section 941 requirements were intended to ensure that securitizers generally have "skin in the game" with respect to securitized loans and other assets.[142]

The risk retention rules were initially proposed by the Joint Regulators in March 2011 (the "Original Proposal")[143] and re-proposed in August 2013 (the "Re-Proposal").[144] The Final Rule will become effective one year from the date of publication in the *Federal Register* for residential mortgage-backed securities ("RMBS") and two years from the date of publication in the *Federal Register* for all other ABS.[145] The Final Rule generally tracks the requirements of the Re-Proposal with minor changes made to address comments submitted or to clarify meaning.

The Final Rule is expected to have a significant impact on securitization markets generally, although the impact is likely to vary considerably among specific asset classes and transaction structures. The impact of the Final Rule extends to the far reaches of the securitization markets, both because it covers privately placed ABS transactions, such as Rule 144A and Regulation D offerings, in addition to publicly offered ABS transactions, and because it applies to foreign issuers that are not willing or able to limit their offerings in the United States to less than 10 percent of the total transaction even in cases where the offering is predominantly foreign in nature.[146]

Sponsors, and in turn originators, will have substantial incentives to produce "qualifying" assets that are exempt from risk retention requirements when securitized.[147] This will be more easily achieved for some asset classes than others.[148] Because of the significant "loosening" of the requirements for "qualified residential mortgages," or QRMs, since the Original Proposal in response to widespread concerns that the definition would inhibit mortgage lending to low- and

141. Credit Risk Retention, Exchange Act Release No. 34-73407, 79 Fed. Reg. 77602 (Dec. 24, 2014) (to be codified at 17 C.F.R. pt. 246). Citations to the Final Rule are to the relevant sections of the securities law, 17 C.F.R. pt. 246, and omit references to parallel sections in other laws.

142. *Id.* at 77643.

143. Credit Risk Retention, Exchange Act Release No. 34-64148, 76 Fed. Reg. 24089 (proposed Apr. 29, 2011).

144. Credit Risk Retention, Exchange Act Release No. 34-70277, 78 Fed. Reg. 57927 (proposed Sept. 20, 2013).

145. Credit Risk Retention, 79 Fed. Reg. at 77602.

146. *Id.* (to be codified at 17 C.F.R. § 246.20).

147. *See, e.g.*, *id.* at 77756 (to be codified at 17 C.F.R. § 246.15).

148. *See, e.g.*, *id.* (to be codified at 17 C.F.R. § 246.16).

moderate-income borrowers, it is expected that a relatively large percentage of residential mortgage loans originated in the United States will qualify as QRMs and can therefore be securitized without a risk retention requirement. In contrast, the requirements for commercial loans, commercial real estate loans, and auto loans remain nearly as strict as initially proposed, and relatively small percentages of loans of these asset types are expected to be "qualifying" assets, such that securitizers of these assets are much more likely than residential mortgage-backed securities, or RMBS, sponsors to be required to retain risk in accordance with the Final Rule.[149]

2. Basic Risk Retention Requirement

As required by the Dodd-Frank Act, the Final Rule generally requires "sponsors" of both public and private securitization transactions to retain not less than 5 percent of the credit risk of the assets collateralizing any ABS issuance.[150] "Sponsor" is defined in the Final Rule as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[151] The Final Rule provides that the credit risk required to be retained and held by a sponsor or any other person under the Rule may be acquired and held by any of such person's majority-owned affiliates, other than the issuing entity.[152] If there is more than one sponsor of a securitization transaction, it is the responsibility of each sponsor to ensure that at least one of the sponsors (or at least one of their majority-owned affiliates, as applicable) retains the required credit risk.[153]

3. Standard Risk Retention Methods

The Final Rule generally permits risk retention to be accomplished through one or a combination of methods: an eligible vertical interest, an eligible horizontal residual interest ("EHRI"), or some combination of the two (an "L-shaped interest").[154] The percentage of the vertical, horizontal, or L-shaped interest to be retained by the sponsor must be determined as of the closing date of the securitization transaction.[155] Horizontal risk retention may be accomplished by holding ABS issued in the transaction or by establishing a cash reserve account for the transaction.[156]

The Final Rule does not include as a standard risk retention method the "representative sample" method included in the Original Proposal but removed in the Re-Proposal.[157] This method would have permitted a sponsor to satisfy its

149. *Id.*
150. *Id.* (to be codified at 17 C.F.R. § 246.4).
151. *Id.* at 77742 (to be codified at 17 C.F.R. § 246.2).
152. *Id.* (to be codified at 17 C.F.R. § 246.3).
153. *Id.* (to be codified at 17 C.F.R. § 246.12).
154. *Id.* (to be codified at 17 C.F.R. § 246.4).
155. *Id.* at 77743.
156. *Id.*
157. *Id.* at 77606.

risk retention obligation by holding, outside of the issuing entity, assets substantially similar to those transferred to an issuing entity in the amount of 5 percent of the assets transferred to the issuing entity.[158] Many commenters on the Re-Proposal urged that this option be restored in the Final Rule, but the Joint Regulators nonetheless declined to adopt this method.[159] Similarly, the Joint Regulators declined to provide options for sponsors to satisfy risk retention requirements by retaining a participation interest in assets transferred to the issuing entity, by providing unfunded credit support such as a guaranty, or through overcollateralization (with limited exceptions).[160]

It should be noted that the Joint Regulators' decision not to permit the retention of a "representative sample" as a risk retention method also impacts another existing securitization regulation. Specifically, in 2010, the FDIC substantially amended its rule for securitizations[161] that sets forth the conditions under which the FDIC will provide a "safe harbor" to investors by agreeing not to repudiate certain contracts or reclaim assets in connection with certain securitizations by insured financial institutions.[162] This FDIC securitization rule in some circumstances requires insured depository institutions to retain credit risk in connection with their securitizations and specifically permits the retention of a "representative sample" of assets of the same type as those securitized.[163] The FDIC securitization rule also contains, however, an "auto-conform" provision to the effect that the risk retention provisions of the securitization rule will be automatically conformed to those ultimately adopted by the Joint Regulators pursuant to section 941 of the Dodd-Frank Act.[164] Accordingly, insured institutions will no longer be permitted to rely on the "representative sample" retention method in order to avail themselves of the FDIC's securitization safe harbor.[165]

a. Eligible Vertical Interest

An "eligible vertical interest" must constitute either (i) a single vertical security entitling the sponsor to the same percentage of amounts paid on each class of ABS interests or (ii) an interest in each class of ABS interests constituting the same proportion of each class of ABS interests.[166]

The Final Rule eliminated the requirement included in the Re-Proposal that an eligible vertical interest be valued using the "fair value" concept applicable to a horizontal interest.[167] Accordingly, a sponsor using the eligible vertical interest

158. *Id.* at 77635.
159. *Id.*
160. *Id.*
161. Transitional Safe Harbor Protection for Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation, 75 Fed. Reg. 12962 (Mar. 18, 2010).
162. *See* 12 C.F.R. § 360.6 (2014).
163. *Id.*
164. *Id.*
165. *Id.*
166. Credit Risk Retention, 79 Fed. Reg. at 77741 (to be codified at 17 C.F.R. § 246.2).
167. *Id.* at 77604.

approach may in effect value the retained interest at par for purposes of the Final Rule.[168]

b. Eligible Horizontal Residual Interest

An "eligible horizontal residual interest," or "EHRI," is an ABS interest in a single class or multiple classes in the issuing entity that represents the most subordinated claim to payments of principal and interest by the issuing entity (with the exception of any non-economic REMIC residual interest, which is not considered an "ABS interest").[169] An EHRI's terms must provide that, if the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the EHRI prior to any reduction in amounts payable to any other ABS interest.[170] Notably, the Final Rule eliminates a provision of the Re-Proposal that would have restricted the payment of cash flow to the EHRI in order to limit how quickly the sponsor could recover in cash the fair value of the interest.[171]

A sponsor utilizing an EHRI to satisfy risk retention requirements must retain an EHRI having a "fair value" (as determined in accordance with GAAP methodologies) of at least 5 percent of the fair value of all ABS interests issued in the transaction.[172] The Final Rule contains extensive requirements for disclosure by the sponsor of its methodology for determining the fair value of the EHRI and of all ABS interests issued.

A reasonable period of time prior to the sale of the ABS, the sponsor must disclose:

- the fair value of all ABS interests to be issued;
- if the fair values of the specific prices, sizes, or rates of interest of each class are not available, a range, and the method to determine the range, of fair values of all ABS interests issued;
- the material terms of the EHRI; and
- a description of the methodology used to calculate fair values, including a description of key inputs and assumptions. [173]

A reasonable time after the closing of the transaction, the sponsor must disclose, based on the actual sale prices and finalized class sizes of the ABS interests:

- the actual fair value of the retained EHRI at closing;
- the amount the sponsor was required to retain at closing under the Final Rule; and

168. *Id.*
169. *Id.* at 77707.
170. *Id.* at 77741 (to be codified at 17 C.F.R. § 246.2).
171. *Id.* at 77742.
172. *Id.* at 77664.
173. *Id.* at 77742 (to be codified at 17 C.F.R. § 246.4).

- any material differences between the actual valuation methodology or inputs and assumptions used from those used for the pre-sale disclosures.[174]

The Final Rule provides sponsors with the option, in lieu of retaining all or any part of an EHRI, to establish and fund, in cash, an "eligible horizontal cash reserve account," or EHCRA, in the amount equal to the required fair value of an EHRI.[175] Amounts in the EHCRA are to be used to satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds to satisfy an amount due on any ABS interest, or to pay critical expenses of the trust unrelated to credit risk on any payment date on which the issuing entity has insufficient funds to pay such expenses.[176] The EHCRA must be held by the trustee until all ABS interests are paid in full.[177]

c. L-shaped Interest

If a sponsor opts to retain both an eligible vertical interest and an EHRI as its required risk retention, the percentage of the fair value of the EHRI and the percentage of the eligible vertical interest must equal at least 5 percent.[178] These percentages must be determined as of the closing date of the securitization transaction.[179]

4. Special Risk Retention Methods

In addition to the standard risk retention methods, the Final Rule includes special risk retention provisions for various specific asset types of transactions. These are described below.

a. Revolving Pool Securitizations

The Final Rule contains special rules for risk retention by sponsors of "revolving pool securitizations," a structure often referred to in industry parlance as the "master trust" structure (whether the issuing entity is actually a trust).[180] This structure is widely used for securitizations of credit card receivables and other revolving assets.[181] The Final Rule defines a "revolving pool securitization" as "an issuing entity that is established to issue on multiple issuance dates more than one series, class, subclass, or tranche of asset-backed securities that are collateralized by a common pool of securitized assets that will change in composition over time, and that does not monetize excess interest and fees from its securitized assets."[182]

174. *Id.* at 77743 (to be codified at 17 C.F.R. § 246.4).
175. *Id.* at 77742 (to be codified at 17 C.F.R. § 246.4).
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.* at 77623.
181. *Id.* (to be codified at 17 C.F.R. § 246.5).
182. *Id.*

The Final Rule permits sponsors of revolving pool securitizations to satisfy their risk retention requirement by maintaining a "seller's interest" of not less than 5 percent of the aggregate unpaid principal balance of all outstanding investor ABS interests in the issuing entity.[183] The Final Rule defines a "seller's interest" as an ABS interest or ABS interests:

- that are collateralized by the securitized assets and servicing assets owned or held by the issuing entity, with certain exceptions;
- that are pari passu with each series of investor ABS interests issued, or partially or fully subordinated to one or more series in identical or varying amounts, with respect to the allocation of all distributions and losses; and
- that adjust for fluctuations in the outstanding principal balance of the securitized assets in the pool.[184]

The Final Rule also permits sponsors of revolving pool securitizations to satisfy risk retention requirements by retaining a horizontal subordinated interest in the pool, with some modifications to the standard requirements for an EHRI to accommodate common features of revolving securitizations.[185] A sponsor may also combine a seller's interest with such an eligible horizontal residual interest to satisfy the 5 percent risk retention requirement.[186]

b. Eligible ABCP Conduits

For issuers of asset-backed commercial paper ("ABCP"), the Final Rule provides "eligible ABCP conduits" with an option to satisfy risk retention requirements other than by using a standard risk retention option.[187] The requirements to qualify as an "eligible ABCP conduit" are complex and beyond the scope of this Review. Generally, however, the assets of an eligible ABCP conduit must be ABS interests and must be issued by one or more intermediate special purpose vehicles ("SPVs").[188] Perhaps most important, the eligible ABCP conduit risk retention option requires that an originator-seller of assets to the intermediate SPV retain the requisite 5 percent credit risk exposure, and that a regulated liquidity provider (as defined) has entered into a legally binding commitment to provide 100 percent liquidity coverage to all ABCP issued by the ABCP issuer by lending to, purchasing ABCP issued by, or purchasing assets from the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit.[189] The eligible ABCP conduit must also comply with extensive disclosure requirements in order to avail itself of this risk retention option.[190]

183. *Id.* at 77744 (to be codified at 17 C.F.R. § 246.5).
184. *Id.*
185. *Id.*
186. *Id.*
187. *Id.* at 77746 (to be codified at 17 C.F.R. § 246.6).
188. *Id.* at 77747.
189. *Id.*
190. *Id.*

c. Commercial MBS

As in the Re-Proposal, commercial mortgage-backed securities, or CMBS, issuers will have the option of satisfying risk retention requirements by transferring up to two pari passu EHRIs, or "B-pieces," to third-party purchasers ("B-Piece Buyers").[191] A B-Piece Buyer must perform its own due diligence of the underlying commercial mortgage loans and may be affiliated with the special servicer.[192] The B-Piece option may be used to satisfy the entire risk retention requirement or may be used in combination with the retention of a vertical interest by the sponsor.[193]

The Final Rule requires that an operating advisor be appointed for any securitization in which the sponsor uses the B-Piece option.[194] The operating advisor is required to act in the best interest of, and for the benefit of, all investors.[195] The operating advisor's purpose is to consult with special servicers on major decisions after the unpaid principal balance of B-Pieces held by third parties is reduced to 25 percent or less of the original principal balance of such B-Pieces, taking into account appraisal reductions and realized losses.[196]

The Final Rule allows transfers of the B-Piece after five years from the closing date of the securitization, whether the B-Piece was retained by the sponsor or by a B-Piece Buyer, provided that the transferee satisfies the requirements applicable to B-Piece Buyers generally.[197] The Final Rule also added a clarification that the risk retention obligation for CMBS terminates once all of the mortgage loans in a CMBS transaction have been fully defeased.[198]

d. Fannie Mae and Freddie Mac ABS

The Final Rule exempts Fannie Mae and Freddie Mac from the risk retention requirements if such entity fully guarantees the timely payment of principal and interest on all ABS interests issued by the issuing entity in the securitization transaction, for so long as Fannie Mae or Freddie Mac, as applicable, is operating under the conservatorship or receivership of the FHFA with capital support from the U.S. Government.[199] This exemption will also apply to any limited-life regulated entity succeeding to the charter of either Fannie Mae or Freddie Mac, provided that the entity is operating with capital support from the U.S. Government.[200]

191. *Id.* at 77748 (to be codified at 17 C.F.R. § 246.7).
192. *Id.*
193. *Id.*
194. *Id.*
195. *Id.* at 77749.
196. *Id.*
197. *Id.*
198. *Id.*
199. *Id.* (to be codified at 17 C.F.R. § 246.8).
200. *Id.* at 77750.

e. Open Market CLOs

The Final Rule treats managers of collateralized loan obligations ("CLOs") as sponsors and generally requires them to satisfy the 5 percent risk retention requirement.[201] The Final Rule also includes a transaction-specific risk retention option for "open-market CLOs" that, subject to certain conditions, permits lead arrangers of senior secured syndicated loans held by the CLO to retain the requisite 5 percent risk, rather than the CLO manager.[202]

f. Qualified Tender Option Bonds

The Final Rule provides that a sponsor with respect to an issuance of tender option bonds (a type of security issued in many securitizations of underlying municipal securities) by a "qualified tender option bond entity" may satisfy its risk retention requirements by holding outside of the issuing entity municipal securities from the same issuance of municipal securities deposited in the qualified tender option bond entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.[203]

A "qualified tender option bond entity" is an issuer of tender option bonds meeting certain requirements, including that the entity be collateralized solely by servicing assets and by municipal securities that have the same municipal issuer or source of payment.[204] Notably, similar to the requirement applicable to an eligible ABCP conduit, the issuing entity must have a legally binding commitment from a regulated liquidity provider to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding tender option bonds.[205] The sponsor must also provide, or cause to be provided, to potential investors certain required disclosures within a reasonable period of time prior to the sale of the bonds.[206] The Final Rule also provides such issuers an option to convert a retained EHRI into an eligible vertical interest upon the occurrence of a "tender option termination event" as defined in section 4.01(5) of IRS Revenue Procedure 2003-84.[207]

5. Transfer of Risk Retention

a. Allocation to an Originator

Under the Final Rule, the sponsor may allocate its risk retention requirements to the originator of the securitized assets under the standard risk retention

201. *Id.* (to be codified at 17 C.F.R. § 246.9).
202. *Id.*
203. *Id.* at 77751 (to be codified at 17 C.F.R. § 246.10).
204. *Id.*
205. *Id.*
206. *Id.*
207. *Id.* at 77752.

options, subject to the agreement of the originator and to certain other conditions.[208] "Originator" is defined to include only the original creditor that created the asset through an extension of credit or otherwise and does not include a subsequent purchaser or transferee of the asset.[209] Any risk retention allocated to an originator reduces the sponsor's risk retention requirements commensurately.[210]

The originator must acquire the eligible interest from the sponsor at the closing of the securitization transaction and retain such interest in the same manner and proportion (as between horizontal and vertical interests) as the sponsor.[211] Additionally, the ratio of the percentage of the risk position acquired and retained by the originator to the total percentage of the risk position otherwise required to be retained by the sponsor may not exceed the ratio of the unpaid principal balance of all securitized assets originated by the originator to the unpaid balance of all the securitized assets in the transaction.[212]

Moreover, the originator must acquire and retain at least 20 percent of the aggregate risk retention amount otherwise required to be held by the sponsor and must comply with the hedging, transfer, and other restrictions (described below) with respect to such interest as if the originator were the sponsor.[213]

b. Hedging, Transfer, and Financing Prohibitions

The Final Rule generally prohibits a sponsor from selling or otherwise transferring any retained interest other than to majority-owned or wholly owned affiliates of the sponsor.[214] Moreover, a sponsor and its affiliates may not hedge their required risk retention positions or pledge those positions as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction), unless the obligation is with full recourse to the pledging entity.[215]

Certain hedging activities are not prohibited.[216] Sponsors and their affiliates are permitted to (i) hedge interest rate or foreign exchange risk or (ii) hedge based on an index of instruments that includes ABS, subject to certain limitations.[217]

The restrictions on sponsors and their affiliates hedging or transferring retained interests for specified periods after the securitization remain unchanged from the Re-Proposal:

- For RMBS transactions, the restrictions will expire on or after the date that is (1) the later of (a) five years after the closing date or (b) the date on which the total unpaid principal balance of the securitized assets is reduced to 25 percent of the original unpaid principal balance as of the

208. *Id.* at 77753 (to be codified at 17 C.F.R. § 246.11).
209. *Id.*
210. *Id.*
211. *Id.*
212. *Id.*
213. *Id.*
214. *Id.* (to be codified at 17 C.F.R. § 246.12).
215. *Id.*
216. *Id.*
217. *Id.*

closing date, but (2) in any event no later than seven years after the closing date.[218]

- For all other ABS transactions, the restrictions will expire on or after the date that is the latest of (1) the date on which the total unpaid principal balance of the securitized assets that collateralize the securitization are reduced to 33 percent of the original unpaid principal balance as of the closing date, (2) the date on which the total unpaid principal obligations under the ABS interests issued in the securitization are reduced to 33 percent of the original unpaid principal obligations as of the closing date, or (3) two years after the closing date.[219]

6. Exceptions and Exemptions

The Final Rule exempts certain types of securitizations from risk retention requirements, including "qualified residential mortgage" loans, or "QRMs," and securitizations backed by auto loans, commercial loans, and commercial real estate loans that meet specified strict underwriting standards.[220]

a. Qualified Residential Mortgages (QRMs)

Under the Final Rule, a sponsor will be exempt from the risk retention requirements for securitizations consisting solely of QRMs. The Final Rule defines "qualified residential mortgage," or QRM, to mean a "qualified mortgage" or QM, as defined in section 129(C) of the Truth in Lending Act and regulations issued thereunder, as amended from time to time, that is not currently thirty or more days past due.[221] The detailed definition of QM is currently set forth in regulations adopted by the Consumer Financial Protection Bureau ("CFPB") under section 129(C) for purposes of the CFPB's "ability-to-repay" rules.[222]

After much debate, the Joint Regulators determined not to adapt the "QM-Plus" concept floated in the Re-Proposal under which QRM would have been defined as a QM that satisfied additional conditions, including a minimum down payment requirement. Thus, under the Final Rule, there is no minimum down payment requirement for a QRM.[223]

The Final Rule also added two limited exemptions from the risk retention requirements for certain residential mortgage loans to conform with the "ability-to-repay" rules of the CFPB.[224] The first is an exemption for securitization transactions backed solely by certain community-focused residential mortgage loans (such as loans made through state housing agency programs and certain

218. *Id.*
219. *Id.*
220. *Id.* at 77754 (to be codified at 17 C.F.R. § 246.13).
221. *Id.*
222. *See* 12 C.F.R. § 1026 (2014).
223. *See* Credit Risk Retention, 79 Fed. Reg. at 77688.
224. *Id.* at 77684.

community lender programs) and servicing assets.[225] The second is an exemption for qualifying three-to-four unit residential mortgage loans and servicing assets.[226] There are also provisions permitting sponsors to blend community-focused loans with non-exempt residential mortgages, in which case the minimum risk retention requirement will be 2.5 percent on qualifying three-to-four unit loans with QRMs, in which case the risk retention requirement will be zero.[227]

b. Qualifying Commercial Loans, Commercial Real Estate Loans, and Auto Loans

The Final Rule provides an exemption from risk retention requirements for securitizations consisting of "qualifying" commercial loans, commercial real estate ("CRE") loans, and automobile loans.[228] Specifically, securitizations of such "qualifying" assets are subject to a 0 percent risk retention requirement provided that:

- the assets meet the specific stringent underwriting standards set forth in the Final Rule for each such asset type;
- the securitization transaction is collateralized solely by loans of the same asset class and by servicing assets;
- the securitization transaction does not permit reinvestment periods; and
- the sponsor provides, or causes to be provided, to potential investors a description of the manner in which the sponsor determined the aggregate risk retention requirement for the securitization transaction.[229]

The underwriting requirements for each of these classes of "qualifying" assets are summarized below.

(i) Qualifying Commercial Loans

The underwriting standards for qualifying commercial loans include the following, among others:

- prior to the origination of the commercial loan, the originator must have verified and documented the financial condition of the borrower at the end of the borrower's two most recently completed fiscal years and during the period, if any, since the end of its most recently completed fiscal year;
- the originator must have determined that, based on the previous two years' actual performance, the borrower had

225. *Id.* at 77760 (to be codified at 17 C.F.R. § 246.19).
226. *Id.* at 77754 (to be codified at 17 C.F.R. § 246.22).
227. *Id.*
228. *Id.* at 77754 (to be codified at 17 C.F.R. § 246.14).
229. *Id.* at 77755.

  - a total liabilities ratio (as defined) of 50 percent or less,
  - a leverage ratio (as defined) of 3.0 or less, and
  - a debt service coverage ("DSC") ratio (as defined) of 1.5 or greater; and
- the originator must also have conducted an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections, and determined that based on such projections that include the new debt obligation, following the closing date of the loan, the borrower will have:
  - a total liabilities ratio of 50 percent or less,
  - a leverage ratio of 3.0 or less, and
  - a DSC ratio of 1.5 or greater.[230]

(ii) Qualifying Commercial Real Estate Loans

The Final Rule defines a qualifying commercial real estate (QCRE) loan as a first lien loan on commercial real estate and improvements, including a ground-leased land loan on improved property, that meets the following underwriting standards, among others:

- a DSC ratio of 1.25 for qualifying multi-family property loans (as defined), 1.5 for qualifying leased CRE loans (as defined), and 1.7 for all other CRE loans;
- a thirty-year maximum amortization period for multi-family loans and a twenty-five-year amortization period for other CRE loans;
- a maximum loan-to-value ("LTV") of 65 percent and a maximum combined LTV of 70 percent;
- the CRE loan must be fixed rate or swapped to a fixed rate through an interest rate swap or capped with an interest rate cap; and
- the CRE loan may not be interest only or have an interest-only period.[231]

(iii) Qualifying Automobile Loans

The Final Rule defines a "qualifying auto loan" as an automobile loan (but not an automobile lease) that satisfies the following underwriting criteria, among others:

- the originator must have verified specified aspects of the borrower's credit history;

230. *Id.* at 77756 (to be codified at 17 C.F.R. § 246.14).
231. *Id.*

- the loan must have a debt-to-income (DTI) ratio of less than or equal to 0.36, as verified through payroll stubs and the borrower's credit report; and
- the borrower must make a down payment of at least (i) 10 percent of the vehicle purchase price plus (ii) all title, tax, and registration fees, dealer fees, and other add-ons.[232]

c. Blending Pools of Qualifying, Exempt, and Non-exempt Assets

Sponsors of RMBS will generally not be allowed to reduce their risk retention requirements by commingling QRM and non-QRM loans in a single securitization, with a limited exception for commingling QRMs and exempt three-to-four unit residential mortgage loans, as described above.[233] However, sponsors of commercial, commercial real estate, or auto loans will be able to reduce their risk retention requirement in proportion to the percentage of "qualifying" assets included by up to 50 percent (that is, to 2.5 percent) using such "blended pools."[234] The issuer must also disclose any material differences between the qualifying and non-qualifying assets included in the pool.[235]

d. Certain Foreign-related Transactions

The Final Rule includes a limited exemption, or "safe harbor," excluding from the risk retention requirements certain predominantly foreign securitizations.[236] The foreign securitization safe harbor is available only if all of the following conditions are met:

- registration of the ABS interests is not required under the Securities Act of 1933;
- not more than 10 percent of the value of all classes of ABS interests (including ABS interests retained by the sponsor) are sold to U.S. persons;
- neither the sponsor nor the issuing entity is organized under U.S. law or is a branch located in the United States of a non-U.S. entity; and
- not more than 25 percent of the securitized assets were acquired from an affiliate or branch of the sponsor organized or located in the United States.[237]

232. *Id.*
233. *See supra* note 226.
234. Credit Risk Retention, 79 Fed. Reg. at 77736 (to be codified at 17 C.F.R. § 246.14).
235. *Id.*
236. *Id.* at 77762 (to be codified at 17 C.F.R. § 246.20).
237. *Id.*

e. General Exemptions

The Final Rule includes a number of "general exemptions" from the risk retention requirements (in addition to the exemptions for certain community-focused residential mortgage loans and certain three-to-four unit residential mortgage loans described above), including the following:

- certain U.S. Government-backed securitizations of residential, multi-family, or healthcare facility mortgage loans that are insured or guaranteed (in whole or in part) by the United States or an agency of the U.S. Government, or that involve the issuance of ABS that are collateralized solely by residential, multi-family, or healthcare facility mortgage loans, which ABS are insured or guaranteed by the United States or an agency of the U.S. Government;
- certain state and municipal securitizations where the ABS are issued or guaranteed by a State, a political subdivision of a State, or by certain public instrumentalities of a State;
- certain qualified scholarship funding bonds;
- certain pass-through resecuritizations that are collateralized solely by servicing assets and by ABS for which the requisite credit risk was previously retained or that were exempt from the credit risk retention requirements, provided that the resecuritization is structured so that it involves the issuance of only a single class of ABS interests;
- certain first-pay-class securitizations structured to reallocate prepayment risk and not credit risk;
- securitizations collateralized solely by "seasoned loans" and by servicing assets;
- certain public utility securitizations; and
- securitizations sponsored by the FDIC acting as conservator or receiver for a financial institution.[238]

There is also a reduced risk retention requirement for certain student loan securitizations where the student loans were made under the Federal Family Education Loan Program ("FFELP"). The risk retention requirement for such securitizations is either 0 percent, 2 percent, or 3 percent, depending on the degree to which such FFELP loan is guaranteed as to default in principal and accrued interest.[239]

238. *Id.* at 77761 (to be codified at 17 C.F.R. § 246.19).
239. *Id.*

f. Additional Exemptions

The Final Rule provides that the Joint Regulators may jointly adopt or issue exemptions, exceptions, or adjustments to the risk retention requirements of the Final Rule. Notably, the Final Rule does not give such authority to individual regulatory agencies.[240]

7. Periodic Review of QRM Definition and Related Exemptions

The Joint Regulators must review the QRM definition, and the related exemptions for community-focused and three-to-four unit residential mortgage loans, four years from the effective date of the Final Rule and every five years thereafter, or at any time upon request by one of the Joint Regulators, to determine if the CFPB's QM definition at such time is still the appropriate definition to use to define QRM and whether such related exemptions are still appropriate.[241]

240. *Id.* at 77763 (to be codified at 17 C.F.R. § 246.21).
241. *Id.* (to be codified at 17 C.F.R. § 246.22).

Accounting Developments 2014

In 2014, the Financial Accounting Standards Board (the "FASB") issued more Accounting Standards Updates (each, an "ASU") to its Accounting Standards Codification ("ASC" or the "Codification") than it has issued since 2010. Of the eighteen ASUs it issued, seven were consensuses of the FASB's Emerging Issues Task Force (the "EITF") and four were consensuses of the FASB's Private Company Council (the "PCC"). In 2010, the FASB issued twenty-nine ASUs, including thirteen that were consensuses of the FASB's EITF.

The EITF, which was formed in 1984, seeks to address emerging accounting issues before divergent approaches to those issues become widespread.[1] The FASB must approve all consensuses reached by the EITF. The EITF is chaired by the FASB's technical director and has members from the auditing profession and from the preparer and financial statement user communities and observers from the FASB, the U.S. Securities and Exchange Commission (the "SEC"), the Financial Reporting Executive Committee of the American Institute of Certified Accountants (the "AICPA"), and the International Accounting Standards Board (the "IASB").

The PCC was formed 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.[2] The FASB must endorse all consensuses reached by the PCC. Similar to the EITF, the members of the PCC are from the auditing profession and from the preparer and financial statement user communities with significant experience auditing, preparing, and using private company financial statements. An FASB member is a liaison to the FASB, and the FASB provides technical and administrative staff to work with the PCC.

The following is a discussion of (a) the ASUs that the FASB issued in 2014 that were not originated by the EITF or the PCC, (b) the ASUs that were originated by the EITF, and (c) the ASUs that were originated by the PCC and only apply to private companies.

1. *See About the EITF*, Fin. Acct. Standards Board, http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1218220137512 (last visited Mar. 16, 2015).

2. *See* Press Release, Fin. Accounting Found., Financial Accounting Foundation Establishes New Council to Improve Standard Setting for Private Companies (May 23, 2012), *available at* http://www.accountingfoundation.org/cs/ContentServer?site=Foundation&c=FAFContent_C&pagename=Foundation%2FFAFContent_C%2FFAFNewsPage&cid=1176160049265.

A. ASUs Originated by the FASB

2014 was a significant year for the FASB because it issued with the IASB the first fully converged major accounting standard, the revenue recognition standard. Its other four substantive standards will reduce the frequency of discontinued operations reporting, eliminate the presentation requirements for development stage companies, require all repurchase agreements to be accounted for as financing transactions, and require going concern disclosures, which are not required by current GAAP. The sixth standard sets forth technical corrections to, and improvements to, definitions in the Codification.

1. Technical Corrections and Improvements Related to Glossary Terms

In March 2014, the FASB issued ASU Update No. 2014-06,[3] which amends the Master Glossary of the Codification in response to comments received from users of the Codification requesting clarifications and other changes that did not require publication of an exposure draft because the changes are of a technical nature.[4] The amendments:

- Delete various terms that were used in superseded accounting literature but are not used in the Codification.[5]
- Add links to the guidance in the Codification that had not been included in the Master Glossary.[6]
- Eliminate duplicative terms.[7]

The amendments were effective upon issuance of ASU 2014-06.[8]

2. Discontinued Operations

In April 2014, the FASB issued ASU Update No. 2014-08,[9] which changes the requirements for when an entity reports a disposition as a discontinued operation.[10] The FASB addressed this topic because some stakeholders advised the FASB that the frequency with which entities were reporting dispositions as discontinued operations was adversely affecting the usefulness of financial

3. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-06, Technical Corrections and Improvements Related to Glossary Terms (Mar. 2014).
4. *Id.* at 1.
5. *Id.* at 2.
6. *Id.*
7. *Id.*
8. *Id.* at 3.
9. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity (Apr. 2014) [hereinafter ASU 2014-08].
10. *Id.* at 1.

statements.[11] In addition, other stakeholders told the FASB that compliance with existing GAAP was complex and resulted in higher costs for preparers.[12] ASU 2014-08 is intended to reduce the disposals that entities report as discontinued operations and improve disclosures about discontinued operations.[13]

Existing GAAP requires an entity to classify a component of its business as a discontinued operation if the entity has either disposed of the component or classified the component as held for sale, "the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction," and "[t]he entity will not have any significant continuing involvement in the operations of the component after the disposal transaction."[14] In some cases, the determination whether an entity will continue to have a significant continuing involvement with the component after the sale may be complex.[15]

ASU 2014-08 changes the definition of discontinued operations to permit discontinued operation treatment only when a disposition of a component, including as a result of a transaction that is not a sale, such as an abandonment or a spinoff, or the classification of a component as held for sale, represents "a strategic shift that has (or will have) a major effect on an entity's operations and financial results."[16] A component is any part of an entity that "can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity."[17] This may be a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group.[18] ASU 2014-08 revises the scope of discontinued operations treatment to also include a disposal of an equity method investment and businesses that are classified as held for sale upon their acquisition.[19]

An entity's sale of a major geographic area, a major line of business, a major equity method investment, or other major parts of its business may qualify for discontinued operations treatment under the amended standard.[20] This change will result in significantly fewer discontinued operations than under current GAAP.[21]

ASU 2014-08 identifies the following criteria for classification of a component as held for sale:

- Management having the requisite authority has committed to a plan for the sale of the component.

11. *Id.*
12. *Id.*
13. *Id.* at 5.
14. *ASC Subtopic 205-20, Presentation of Financial Statements—Discontinued Operations*, Fin. Acct. Standards Board ¶ 205-20-45-1, https://asc.fasb.org/ (last visited Apr. 28, 2015).
15. ASU 2014-08, *supra* note 9, at 62.
16. *Id.* at 1.
17. *Id.* at 2.
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.* at 5.

- The component is available for immediate sale in its present condition.
- The entity has begun an active program and other actions required to complete the plan to sell the component.
- The sale of the component is probable within one year.
- The component is being actively marketed for sale at a reasonable price.
- Significant changes to and withdrawal of the disposal plan are not likely.[22]

ASU 2014-08 has two additional presentation changes from current GAAP. It requires entities also to present the assets and liabilities of the discontinued operation separately on the balance sheet[23] and to present in the statement of cash flows or disclose in the notes to the financial statements either (1) the total operating and investing cash flows of the discontinued operation for the periods in which the results of operations for the discontinued operation are presented in the income statement or (2) the depreciation, amortization, capital expenditures, and significant operating and investing noncash items of the discontinued operation for those periods.[24]

Finally, ASU 2014-08 requires expanded disclosures about the discontinued operation, including information about the disposal or expected disposal, any changes to the plan of disposition,[25] any continuing involvement of the entity with the discontinued operation,[26] the pretax profit and loss of the discontinued operation and the major classes of line items constituting the pretax profit or loss of the discontinued operation except for a discontinued operation that was an equity method investment before the disposal,[27] information about any noncontrolling interest in the discontinued operation,[28] and the carrying amounts of the major classes of assets and liabilities included as part of a discontinued operation classified as held for sale.[29] Finally, it requires an entity to disclose information about the financial effects of significant disposals that do not qualify for discontinued operations reporting.[30]

ASU 2014-08 is effective:

- For public entities—for all components of an entity that are disposed of (or classified as held for sale), and all acquired businesses that, upon acquisition, are classified as held for sale, during annual periods beginning on or after December 15, 2014, and interim periods within those years.[31]

22. *Id.* at 15.
23. *Id.* at 2.
24. *Id.* at 23.
25. *Id.* at 20–21.
26. *Id.* at 4.
27. *Id.* at 22–23.
28. *Id.* at 23.
29. *Id.* at 20–21.
30. *Id.* at 3–4.
31. *Id.* at 6.

- For other entities—for all components of an entity that are disposed of (or classified as held for sale), and all acquired businesses that, upon acquisition, are classified as held for sale, during annual periods beginning on or after December 15, 2014, and interim periods within annual periods beginning on or after December 15, 2015.[32]

Implementation of the standard for components or businesses classified as held for sale before the effective date is not permitted, even if the component or business is disposed of after the effective date.[33] Early adoption is only permitted for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issuance.[34]

3. Revenue Recognition

In May 2014, the FASB issued ASU Update No. 2014-09,[35] which establishes a framework for the recognition of revenue from contracts with customers[36] in a standard that has only minor differences from the standard issued concurrently by the IASB.[37] ASU 2014-09 supersedes most existing industry and other accounting guidance related to the accounting for revenue arising from contracts with customers by U.S. companies. The IASB's standard provides for the first time comprehensive revenue recognition requirements. The converged standards are intended to achieve the following goals:

- "Remove inconsistencies and weaknesses in existing revenue requirements";
- "Provide a more robust framework for addressing revenue issues";
- "Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets";
- "Provide more useful information to users of financial statements through improved disclosure requirements"; and
- "Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer."[38]

The "core principle" of the new standard is that an entity should recognize revenue from the transfer of "goods or services to a customer in an amount

32. *Id.*
33. *Id.*
34. *Id.*
35. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) (May 2014) [hereinafter ASU 2014-09].
36. *Id.* § C, at 517.
37. The minor differences between ASU 2014-09 and the IASB's International Financial Reporting Standard 15, Revenue from Contracts with Customers (May 2014), include the collectibility threshold, interim disclosure requirements, and impairment loss reversal. ASU 2014-09, *supra* note 35, § A, at 10–11.
38. ASU 2014-09, *supra* note 35, at 1.

that reflects the consideration to which the entity expects to be entitled in exchange for these goods or services."[39] The standard identifies a five-step process for the evaluation of the timing of the recognition of revenue and the amount of revenue to be recognized.[40] These steps are the following:

- Step 1: Identify the contract or contracts with the customer and make sure that the contract meets various criteria including that it is probable that the entity will collect the consideration to which it will be entitled once it transfers the promised good or service to the customer.[41]
- Step 2: Identify the performance obligations in the contract and determine whether they are separate or distinct obligations.[42] A performance obligation is distinct if (1) "[t]he customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer" and (2) "[t]he promise to transfer the good or service is separately identifiable from other promises in the contract."[43]
- Step 3: Determine the transaction price, or amount to which the entity is entitled once it transfers the promised good or service to the customer, by considering the following, among other things:
  - Discounts, credits, price concessions, returns, and performance bonuses/penalties that may be considered to be variable consideration. Variable consideration may only be included in the transaction price to the extent that it is "probable" that the variable consideration will not be reversed.
  - Any significant financing component in the contract that results from the timing of the customer's payment differing by more than a year from the transfer date of the promised good or service to the customer, in which case the transaction price should be adjusted for the time value of money.
  - Any noncash consideration being paid by the customer.
  - Any consideration payable to the customer, such as vouchers and coupons, any variable and noncash consideration, the timing of the receipt of the consideration, and any consideration payable to the customer.[44]
- Step 4: Allocate the transaction price to each performance obligation in the contract based on the standalone selling price or an estimate of such a standalone price and determine whether and how any discount or variable consideration should be allocated to any distinct performance obligations.[45]

39. *Id.* at 2.
40. *Id.*
41. *Id.*
42. *Id.* at 3.
43. *Id.*
44. *Id.* at 3–4, 32.
45. *Id.* at 4–5.

- Step 5: Recognize revenue when or as the promised good or service is transferred to the customer and the customer obtains control of the good or service.[46] When revenue is to be recognized over time, such as for contracts relating to the transfer of services to a customer, an entity must determine an appropriate method for measuring its progress in completing the performance obligation.[47]

ASU 2014-09 also provides guidance for when an entity should account for costs to obtain or fulfill a contract with a customer as an asset. An entity is required to recognize as an asset costs that it would not have incurred if it had not obtained the contract, defined as incremental costs, as long as the entity expects to recover those costs.[48] An example of an incremental cost is a sales commission.[49] If the amortization period for the asset is one year or less, however, the entity may account for the cost as an expense.[50] Expense treatment is required, however, for costs to obtain a contract if the entity would have incurred the costs regardless of whether the contract was obtained.[51] Costs to fulfill a contract that are not covered by other standards, such as the standards relating to inventory; property, plant, and equipment; internal-use software; and costs of software to be sold, leased, or marketed, may only be recognized as an asset if the costs relate directly to a contract or an anticipated contract, the costs generate or enhance resources that the entity will use in satisfying the performance obligation, and the entity expects to recover the costs.[52]

A significant change to existing GAAP will result from the principles-based disclosure requirements in ASU 2014-09.[53] The disclosure requirements are intended to enable users to understand the nature, amount, timing, and uncertainties relating to the revenue and cash flows arising from an entity's contracts with customers.[54] The new standard requires disclosures of quantitative and qualitative information about the following:

- Its contracts with customers, including:
  - The amount of revenue received from customers, shown on a disaggregated basis. An entity will be required to develop categories of customers based on its consideration of how the entity presents revenue information for other purposes, such as in earnings releases, annual reports or investor presentations, and in information regularly reviewed by the

46. *Id.* at 5.
47. *Id.* at 6.
48. *Id.*
49. PricewaterhouseCoopers, A Look at Current Financial Reporting Issues—Revenue from Contracts with Customers 17 (June 11, 2014), *available at* http://www.pwc.com/en_US/us/cfodirect/assets/pdf/in-depth/2014-01-revenue-from-contracts-with-customers.pdf.
50. ASU 2014-09, *supra* note 35, § A, at 6.
51. *Id.* at 144.
52. *Id.* at 6.
53. *Id.* at 8–9.
54. *Id.*

chief operating decision maker for evaluating the financial performance of operating segments.[55]

- The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers; revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period; and revenue recognized in the reporting period from performance obligations satisfied or partially satisfied in previous periods, such as changes in the transaction price.[56]

- Information about the entity's performance obligations in contracts with customers, including when the entity satisfies a performance obligation (i.e., upon shipment, delivery, when services are rendered, or upon completion of service), including when performance obligations are satisfied in a bill-and-hold arrangement; the significant payment terms, such as whether the contract has a significant financing component and whether consideration is variable; and the transaction price that is allocated to the remaining performance obligations in a contract.[57]

- The judgments, and changes in judgments, made in applying the standard that significantly affect the determination of the amount and timing of revenue from the contracts with customers, including:

  - The timing of satisfaction of the performance obligations.

  - The methods, inputs, and assumptions used to determine the transaction price, assess the extent to which variable consideration can be recognized, allocate the price, including estimating standalone selling prices and allocating discounts and variable consideration to a specific part of the contract if applicable, and measure obligations for returns, refunds, and other similar obligations.[58]

- Any assets recognized from the costs to obtain or fulfill a contract with a customer.[59]

Recently, the FASB has tentatively decided to extend the effective dates of ASU 2014-09 by one year.[60] ASU 2014-09 is effective as follows:

- For public companies—for any annual period (including interim reporting periods within those periods) beginning after December 15, 2016. In complying with the effective date, an entity must either:

55. *Id.* at 68.
56. *Id.* at 44.
57. *Id.* at 45–46.
58. *Id.* at 47.
59. *Id.* at 6.
60. *See Tentative Board*, Fin. Acct. Standards Board (Apr. 1, 2015), http://www.fasb.org/cs/ContentServer?c=FASBContent_c&pagename=FASB%2FFASBContent_c%2FActionAlertPage&cid=1176165906245.

- retrospectively apply the standard in the financial statements for each prior reporting period presented (for example, an entity preparing financial statements for its fiscal year ending December 31, 2017, would need to include retrospectively adjusted income statements for its fiscal years ended December 31, 2016 and 2015 as well), except that an entity would be entitled to not restate revenue recognized for completed contracts that began and ended in the same annual reporting period and to use the transaction price on the date the contract was completed for any completed contracts that have variable consideration; or
- retrospectively with the cumulative effect of applying the standard recognized when the standard is first implemented.[61]

- For other entities—for annual periods beginning after December 15, 2017, and interim reporting periods within annual periods beginning after December 15, 2018.[62]

The effective date of ASU 2014-09 is one of the issues that the Joint Transition Resource Group for Revenue Recognition (the "TRG") formed by the FASB and the IASB is addressing.[63] At their February 18, 2015, and March 18, 2015, meetings, the FASB and the IASB decided to issue proposals to improve those aspects of their respective standards that relate to licenses of intellectual property and the identification of performance obligations,[64] and reached various decisions related to the transition to the new standard.[65] In addition, the FASB decided to provide relief relating to the transition to the requirement in ASU 2014-09 that sales taxes collected from customers be excluded from the transaction price and decided to provide guidance about noncash consideration and collectibility.[66] The TRG is also considering the adequacy of the guidance related to the determination to recognize revenue on a gross versus a net basis.[67]

4. Development Stage Companies

In June 2014, the FASB issued ASU Update No. 2014-10,[68] which eliminates from GAAP the concept of a development stage entity by deleting the require-

61. *Id.* at 9–10.
62. *Id.* at 9.
63. *See Tentative Board Decisions*, *Project Update*, Fin. Acct. Standards Board (Feb. 18, 2015), http://www.fasb.org/jsp/FASB/FASBContent_C/ActionAlertPage&cid=1176164947028.
64. *Id.*
65. *See Tentative Board Decisions*, Fin. Acct. Standards Board, (Mar. 18, 2015), http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FActionAlertPage&cid=1176165876584.
66. *Id.*
67. *See Project Update, Revenue from Contracts with Customers*, Fin. Acct. Standards Board (Mar. 3, 2015), *available at* http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176165844360#decisions.
68. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-10, Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an

ments of ASC Topic 915,[69] removes the criterion that references a development stage entity in ASC Topic 810 relating to the determination whether an entity is a variable interest entity ("VIE"),[70] and clarifies that the guidance in ASC Topic 275, Risks and Uncertainties, is applicable to entities that have not commenced planned principal operations.[71] This project originated with a recommendation of the PCC that the FASB add a project to its technical agenda to determine whether the required presentation of inception-to-date information by a development stage entity should be amended or eliminated in the financial statements for private development stage entities.[72] The FASB expanded the scope to address both public and private development stage entities in light of comments of preparers and investors and other users of financial statements that the inception-to-date information and the other applicable disclosures were costly to prepare and the disclosures were not useful.[73]

ASU 2014-10 removes the definition of a development stage entity.[74] Existing GAAP defines a development stage entity as an entity that has not yet commenced planned principal operations or has not yet produced significant revenue from commenced planned principal operations.[75] ASU 2014-10 also eliminates the requirements that development stage entities:

- "present inception-to-date information in the statements of income, cash flows, and shareholder equity";
- "label the financial statements as those of a development stage entity";
- describe "the development stage activities in which the entity is engaged"; and
- "disclose in the first year in which the entity is no longer a development stage entity that in prior years it had been in the development stage."[76]

ASU 2014-10 also removes ASC paragraph 810-10-15-16. Paragraph 810-10-15-16 states that a development stage entity does not meet the condition in paragraph 810-10-15-14(a) to be a VIE if (1) the entity can demonstrate that its equity is sufficient to permit it to finance the activities in which it is currently engaged and (2) the entity's governing documents and contractual arrangements allow additional equity investments.[77] Under the amendments, all entities within the scope of the variable interest entities paragraphs of Subtopic 810-10,

Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation (June 2014) [hereinafter ASU 2014-10].

69. *Id.* at 2.

70. *Id.*

71. *Id.* at 3.

72. *Id.* at 23.

73. *Id.* at 1, 23.

74. *Id.* at 2.

75. *Master Glossary, Accounting Standards Codification*, FIN. ACCT. STANDARDS BOARD, https://asc.fasb.org/glossary&letter=D (last visited Mar. 27, 2015).

76. ASU 2014-10, *supra* note 68, at 3.

77. *ASC Subtopic 810-10, Consolidations—Overall*, FIN. ACCT. STANDARDS BOARD, ¶ 810-10-15-16, https://asc.fasb.org/section&trid=2197490 (last visited Apr. 27, 2015).

Consolidation—Overall, will be required to evaluate whether the total equity investment at risk is sufficient using the guidance provided in paragraphs 810-10-25-45 through 25-47, which requires both qualitative and quantitative evaluations.[78]

The amendments also clarify that the guidance in ASC Topic 275, Risks and Uncertainties, is applicable to entities that have not commenced planned principal operations.[79] An illustration has been added to Topic 275 to demonstrate how an entity that has not commenced planned principal operations may comply with the disclosure required by ASC paragraph 275-10-50-2.[80]

ASU 2014-10 is effective as follows:

- Elimination of ASC Topic 915 applicable to development stage entities, on a retrospective basis:
    - For public companies—for annual reporting periods beginning after December 15, 2014, and interim periods therein;[81] and
    - For other companies—for annual reporting periods beginning after December 15, 2014, and interim reporting periods beginning after December 15, 2015.[82]
- Clarification of ASC Topic 275 relating to disclosure about risks and uncertainties related to an entity's activities when the entity has not begun planned principal operations, on a prospective basis:
    - For public companies—for annual reporting periods beginning after December 15, 2014, and interim periods therein;[83] and
    - For other companies—for annual reporting periods beginning after December 15, 2014, and interim reporting periods beginning after December 15, 2015.[84]
- Elimination of the exception to the sufficiency-of-equity-at-risk criterion for development stage entities in ASC paragraph 810-10-15-16, on a retrospective basis:
    - For public companies—for annual reporting periods beginning after December 15, 2015, and interim reporting periods therein;[85] and
    - For other companies—for annual periods beginning after December 15, 2016, and interim reporting periods beginning after December 15, 2017.[86]

78. ASU 2014-10, *supra* note 68, at 2.
79. *Id.*
80. *Id.* at 9.
81. *Id.* at 4.
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.*

Early adoption is permitted for any annual or interim reporting period for which the entity's financial statements have not yet been issued.[87]

5. Repurchase Agreements

In June 2014, the FASB issued ASU Update No. 2014-11,[88] which requires secured borrowing treatment for a repurchase agreement that matures at the same time as the transferred financial asset (a repurchase-to-maturity transaction) and for a repurchase financing executed contemporaneously with an initial transfer of a financial asset to the same counterparty.[89] It also requires new disclosures about repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings and about transactions that involve a transfer of a financial asset accounted for as a sale.[90] The FASB undertook this project to address comments that all repurchase agreements should be accounted for in the same way because the transferor in all of the different types of repurchase agreements retains exposure to the transferred financial assets and obtains important benefits of those assets throughout the term of the transaction.[91] The new disclosures are intended to increase transparency about the types of collateral pledged in secured borrowing transactions and enable users to better understand transactions in which the transferor retains substantially all of the exposure to the economic return on the transferred financial asset throughout the term of the transaction.[92]

Under current GAAP, a repurchase-to-maturity transaction is generally regarded as transferring effective control from the transferor.[93] As long as the other conditions for derecognition of an asset are met (that is, isolation and the transferee's right to pledge or exchange the asset), the repurchase-to-maturity transaction is accounted for as a sale and a forward repurchase agreement (generally, a derivative under ASC 815, Derivatives and Hedging).[94] Under current GAAP, a repurchase financing executed at the same time as an initial transfer of the financial asset to the same counterparty is accounted for generally as a derivative if the two transactions are required to be linked in their accounting.[95] The amendments to ASC Topic 860 will require a repurchase-to-maturity transaction to be accounted for as a secured borrowing.[96] In addition, ASU 2014-11 will require separate accounting for the repurchase agreement and the initial transfer of the financial

87. *Id.*
88. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-10, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures (June 2014).
89. *Id.* at 2.
90. *Id.*
91. *Id.* at 1.
92. *Id.* at 3–4.
93. *Id.* at 3.
94. *Id.*
95. *Id.*
96. *Id.*

asset.[97] Therefore, the transferor will account for the initial transfer as a sale of a financial asset (if all of the derecognition criteria are met), the initial transferee will account for the initial transfer as a purchase, and both parties will account for the repurchase agreement component of the transaction as a secured borrowing.[98] ASU 2014-11 also includes guidance for the evaluation of whether a transferor maintains effective control over the transferred financial asset.[99]

The new disclosures required by the amendments to ASC Topic 860 expand the current required disclosures about a transferor's continuing involvement with transferred financial assets and about collateral pledged in various types of secured lending agreements.[100] ASU 2014-11 requires two new types of disclosure. With respect to a transfer of a financial asset accounted for as a sale in which the transferor retains substantially all of the exposure to the economic return on the transferred asset through an agreement with the same counterparty, the transferor entity will be required to disclose the following information by type of transaction (for example, repurchase agreement, securities lending arrangement, and a sale with a total return swap):

- The carrying amount of the financial asset derecognized as of the date of derecognition;
- The amount of gross proceeds received by the transferor at the time of such financial asset derecognition;
- The "transferor's ongoing exposure to the economic return on the transferred financial [asset]"; and
- The amount reported in the statement of financial position arising from the transaction, such as that represented by a derivative contract.[101]

With respect to repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions that are accounted for as secured borrowings, ASU 2014-11 requires the following information for each interim and annual period about the collateral pledged and the transferor's continuing risks under such transactions:

- "A disaggregation of the gross obligation by the class of collateral pledged";
- The remaining contractual maturity of the financing arrangement; and
- "A discussion of the potential risks associated with the [arrangements] and the related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed."[102]

97. *Id.*
98. *Id.*
99. *Id.* at 18–20.
100. *Id.* at 3.
101. *Id.* at 24–25.
102. *Id.* at 26–27.

ASU 2014-11 is effective as follows:

- For public companies:
  - the accounting changes are effective for the first interim or annual period beginning after December 15, 2014;[103] and
  - the disclosure about certain transactions accounted for as a sale is required to be presented for interim and annual periods beginning after December 15, 2014, and the disclosure about repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and for interim periods beginning after March 15, 2015.[104]
- For other entities, the accounting and disclosure changes are effective for annual periods beginning after December 15, 2014, and interim periods beginning after December 15, 2015.[105]

6. Going Concern

In August 2014, the FASB issued ASU Update No. 2014-15,[106] which is a new accounting standard, codified as ASC 205-40, intended to reduce the diversity in disclosures regarding substantial doubt about an entity's ability to continue as a going concern.[107] The FASB undertook this project in October 2008 in response to concerns about this diversity and the fact that entities have been providing going concern disclosures in their financial statements, not as a result of an accounting requirement, but as a result of an auditing standard and an SEC requirement.[108] The Company Accounting Oversight Board ("PCAOB") adopted the auditing standard on an interim basis shortly after its formation.[109] The SEC has required going concern disclosures since 1970, most recently by Financial Reporting Release No. 16.[110] Section 10A of the Securities Exchange Act of 1934, as amended, requires auditors to evaluate "whether there is substantial

103. *Id.* at 4.
104. *Id.*
105. *Id.*
106. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-15, Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern (Aug. 2014) [hereinafter ASU 2014-15].
107. *Id.* at 1.
108. *See id.*
109. In 1989, the Auditing Standards Board of the AICPA adopted SAS No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, which the PCAOB codified on an interim basis shortly after its formation in Rule 3200T, Interim Auditing Standards, as PCAOB Auditing Standard Section 341.
110. In 1970, the SEC issued Accounting Services Release No. 115, Certification of Financial Statements (Feb. 19, 1970), which was rescinded and superseded by Financial Reporting Release No. 16, Rescission of Interpretation Relating to Certification of Financial Statements, 49 Fed. Reg. 6707 (Feb. 23, 1984), *available at* http://www.heinonline.org/HOL/Page?public=false&handle=hein.fedreg/049037&page=6707&collection=fedreg.

doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year."[111]

This evaluation of the ability of an entity to continue as a going concern is necessary because financial statements are prepared based on the assumption that the reporting entity is a going concern.[112] If an entity's liquidation is imminent, financial statements must be prepared under the liquidation basis of accounting.[113] When an entity's liquidation is not imminent but there are events or conditions that raise substantial doubt about the entity's ability to continue as a going concern, companies have included in the footnotes to their financial statements information about those events or conditions. It was the diversity in this footnote disclosure that led to requests that the FASB address this area.

ASU 2014-15 requires an entity to include disclosure in a footnote to its financial statements whenever management concludes that there is a substantial doubt about the entity's ability to continue as a going concern.[114] ASU 2014-15 differs from the applicable auditing standard and the SEC's guidance in the following ways:

- It defines "substantial doubt";
- It requires management to make a going concern assessment every interim and annual period;
- It provides guidance for the consideration of management's plans to alleviate the doubt;
- It requires certain disclosures when those plans do alleviate the going concern doubt;
- It requires an express statement about the substantial doubt and certain disclosures when the plans do not alleviate the going concern doubt; and
- It requires an assessment of substantial doubt for a period of one year after the date that the financial statements are issued.[115]

ASU 2014-15 defines "substantial doubt" as existing when, based on all known and reasonably knowable conditions and events, "it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued."[116] The term "probable" in the definition means that the event is likely to occur.[117] That is

111. The Private Securities Litigation Reform Act, enacted in 1995, amended the Securities Exchange Act of 1934 to add section 10A, which specifies this scope to an audit in section 10A(a)(3).
112. ASU 2014-15, *supra* note 106, at 1.
113. *Id.*
114. *Id.* at 2.
115. *Id.* at 3.
116. *Id.* at 2.
117. *Master Glossary, Accounting Standards Codification*, Fin. Acct. Standards Board, https://asc.fasb.org/glossary&letter=D (last visited Mar. 27, 2015).

the same definition of "probable" in the FASB's standard relating to the accounting for and disclosures about loss contingencies, ASC Subtopic 450-20.[118]

Management must evaluate whether relevant conditions and events known and reasonably knowable as of the date the financial statements are issued, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued.[119] Examples of conditions and events that should be considered are:

- "The entity's current financial condition, including its liquidity sources";
- "The entity's conditional and unconditional obligations due or anticipated within one year after the date that the financial statements are issued";
- "The funds necessary to maintain the entity's operations considering its current financial condition, obligations, and other expected cash flows within one year after the date that the financial statements are issued"; and
- Other conditions such as "[n]egative financial trends" and "[o]ther indications of possible financial difficulties"; "[i]nternal matters, . . . [such as] labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, and a need to significantly revise operations"; and "[e]xternal matters, for example, legal proceedings, legislation, or similar matters that might jeopardize the entity's ability to operate; loss of a key franchise, license or patent; loss of a principal customer or supplier; and an uninsured or underinsured catastrophe."[120]

When management identifies conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, it must consider, based on information available as of the date the financial statements are issued, whether it has one or more plans that will alleviate the substantial doubt.[121] To be considered, management or the board must have approved the plan, it must be probable that the plan or plans will be effectively implemented within one year after the date the financial statements are issued, and it must be probable that the plan or plans, when implemented, will mitigate the relevant conditions or events that raised the substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued.[122]

If management concludes that its plans alleviate the substantial doubt, it must disclose the following in the footnotes:

118. ASU 2014-15, *supra* note 106, at 2.
119. *Id.*
120. *Id.* at 8.
121. *Id.* at 9.
122. *Id.*

- The principal conditions or events that gave rise to its substantial doubt;
- Its "evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations"; and
- Its plans to alleviate the substantial doubt.[123]

If management continues to have substantial doubt about the entity's ability to continue as a going concern, it must expressly disclose in the footnotes its substantial doubt as well as the following:

- The principal conditions or events that gave rise to its substantial doubt;
- Its "evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations"; and
- Its plans that are intended to mitigate the conditions or events that raise the substantial doubt.[124]

ASU 2014-15 is effective for fiscal years ending after December 15, 2016, with early adoption permitted.[125]

The Standard-Setting Agenda issued by the PCAOB's Office of the Chief Auditor on December 31, 2014, states that the PCAOB's staff is evaluating whether revisions should be made to the PCAOB's existing standard on the auditor's going concern evaluation in light of the new accounting standard.[126] The staff agenda states that the staff expects to issue a staff consultation paper in the first quarter of 2015 seeking public comment on potential approaches to revising the performance and reporting requirements of the existing auditing standard.[127]

B. ASUs Originated by the EITF

The EITF addresses financial reporting issues within the existing framework of the Codification in order to reduce diversity in the interpretation or implementation of existing GAAP. Six of the seven ASUs issued in response to EITF consensuses address diversity of implementation of standards. One of the ASUs was issued to provide guidance where none existed.

1. Investments in Qualified Affordable Housing Projects

In January 2014, in response to an EITF consensus, the FASB issued ASU Update No. 2014-01,[128] which provides guidance for when an entity that invests in

123. *Id.* at 2–3.
124. *Id.* at 3.
125. *Id.* at 4.
126. PCAOB, Office of the Chief Auditor: Standard-Setting Agenda 5 (Dec. 31, 2014), *available at* http://pcaobus.org/Standards/Documents/201412_Standard_Setting_Agenda.pdf.
127. *Id.*
128. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-01, Investment—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects, a consensus of the FASB Emerging Issues Task Force (Jan. 2014).

qualified affordable housing projects may elect to use the proportional amortization method to account for its investment rather than the equity or the cost method.[129] ASU 2014-01 is "expected to enable more entities to qualify for the proportional amortization method to account for affordable housing project investments than the number of entities that currently qualify for the effective yield method."[130] In addition, the EITF believes that the amendments in ASU 2014-01 "will help enhance financial statement users' understanding of the nature of qualified affordable housing project investments and their effect on the financial position and results of operations of a reporting entity."[131]

ASU 2014-01 sets forth various conditions that an entity must meet in order to use the proportional amortization method to account for its investment in a flow-through limited liability entity that manages or invests in affordable housing projects that qualify for the low-income housing tax credit.[132] If an entity meets the conditions, it may elect to amortize the initial cost of the investment in proportion to the amount of tax credits and other tax benefits received and recognize the net investment performance in the income statement as a component of income tax expense (benefit).[133]

ASU 2014-01 also includes new disclosure requirements applicable to all investments in qualified affordable housing projects regardless of how an entity accounts for the investment.[134]

ASU 2014-01 is effective:

- For public business entities—for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014;[135] and
- For other entities—for annual periods beginning after December 15, 2014, and interim periods within annual reporting periods beginning after December 15, 2015.[136]
- Early adoption is permitted.[137] When adopted, the new guidance must be applied retrospectively to all periods presented except for any investments in qualified affordable housing projects that the entity accounted for using the effective yield method before the date of adoption.[138]

129. *Id.* at 1.
130. *Id.* at 4.
131. *Id.*
132. *Id.* at 2.
133. *Id.*
134. *Id.* at 3.
135. *Id.* at 4.
136. *Id.*
137. *Id.*
138. *Id.* at 20.

2. Mortgage Loans

In January and August 2014, in response to EITF consensuses, the FASB issued two standards related to mortgage loans. In January, the FASB issued ASU Update No. 2014-04,[139] which clarifies "when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized."[140] ASU 2014-04 is intended to address diversity resulting from the absence of definitions of the terms "in substance a repossession or foreclosure" and "physical possession."[141]

ASU 2014-04 provides that a creditor has received physical possession of residential real estate property collateralizing a consumer mortgage loan through an in substance repossession or foreclosure upon either:

- "the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure," or
- "the borrower conveying all interest in the residential real estate property to the creditor to satisfy [the] loan through completion of a deed in lieu of foreclosure or through a similar legal agreement."[142]

ASU 2014-04 is effective:

- For public business entities—for annual periods, and interim periods within those annual periods, beginning after December 15, 2014,[143] and
- For other entities—for annual periods ending after December 15, 2014, and interim periods beginning after December 15, 2015.[144]

In August, the FASB issued ASU Update No. 2014-14,[145] which clarifies how a creditor should classify foreclosed mortgage loans that are either fully or partially guaranteed under government programs.[146] ASU 2014-14 was issued to address the lack of guidance on how to classify or measure foreclosed mortgage loans that are government guaranteed.[147]

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139. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-01, Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure, a consensus of the FASB Emerging Issues Task Force (Jan. 2014).
140. *Id.* at 1.
141. *Id.*
142. *Id.* at 2.
143. *Id.*
144. *Id.*
145. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-14, Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure, a consensus of the FASB Emerging Issues Task Force (Aug. 2014).
146. *Id.* at 1.
147. *Id.* at 2.

ASU 2014-14 requires an entity to derecognize a mortgage loan and recognize a separate receivable upon foreclosure under the following circumstances:

1. The loan has a government guarantee that is not separable from the loan before foreclosure.
2. At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee and the creditor has the ability to recover under that claim.
3. At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed.[148]

The receivable recognized upon foreclosure must be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor.[149]

ASU 2014-14 is effective:

- For public business entities—for annual periods, and interim periods within those annual periods, beginning after December 15, 2014,[150] and
- For other entities—for annual periods ending after December 15, 2015, and interim periods beginning after December 15, 2015.[151]

ASU 2014-14 may be implemented on either a prospective or a modified prospective basis, as explained in the standard, except that an entity must implement this standard in the same way that it implements ASU 2014-04.[152] An entity may early adopt ASU 2014-14 only if it has already adopted the amendments to ASU 2014-04.[153]

3. Service Concession Arrangements

In January 2014, in response to an EITF consensus, the FASB issued ASU Update No. 2014-05,[154] which prohibits an operating entity from accounting for a service concession arrangement covered by the standard as a lease in accordance with ASC Topic 840, Leases,[155] or for the infrastructure used in such an arrangement as property, plant, or equipment of the operating entity.[156] ASU 2014-05 defines a service concession arrangement as "an arrangement between a public-sector entity grantor and an operating entity under which the operating entity operates the grantor's infrastructure (for example, airports, roads, and bridges). The operating entity also may provide the construction, upgrading, or maintenance

148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.* at 2–3.
152. *Id.* at 3.
153. *Id.*
154. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-05, Service Concession Arrangements (Topic 853), a consensus of the FASB Emerging Issues Task Force (Jan. 2014).
155. *Id.* at 1.
156. *Id.*

services of the grantor's infrastructure."[157] The FASB's summary of the standard observes that public-sector entities may increasingly use service concession arrangements as an efficient and cost-effective way to provide public services.[158]

The service concession arrangements covered by ASU 2014-05 are those in which the public-sector entity grantor:

- "controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price," and
- "controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement."[159]

ASU 2014-05 provides that an operating entity with a service concession arrangement covered by the standard must refer to other topics in the Codification for guidance on accounting for the various aspects of the service concession arrangement.[160]

ASU 2014-05 is effective:

- For public business entities—for annual periods, and interim periods within those annual periods, beginning after December 15, 2014,[161] and
- For other entities—for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015.[162]

Early adoption is permitted.[163] When adopted, the new guidance must be applied on a modified retrospective basis to service concession arrangements that exist at the beginning of an entity's fiscal year of adoption with the cumulative effect of compliance recognized as an adjustment to the opening retained earnings balance for the annual period of adoption.[164]

4. Share-Based Awards with a Performance Target Achievable After the Requisite Service Period

In June 2014, in response to an EITF consensus, the FASB issued ASU Update No. 2014-12,[165] which provides that a performance target of a share-based

157. *Id.* (footnote omitted).
158. *Id.*
159. *Id.*
160. *Id.*
161. *Id.* at 2.
162. *Id.*
163. *Id.*
164. *Id.*
165. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-12, Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period, a consensus of the FASB Emerging Issues Task Force (June 2014).

award that affects vesting and that can be met after a person has completed the requisite service period should be accounted for as a performance condition under ASC Topic 718.[166] ASU 2014-12 is intended to address the diversity in accounting for these share-based awards given the absence of explicit applicable guidance in current GAAP.[167]

The guidance in ASU 2014-12 applies to all share-based awards that provide that a performance target that affects vesting can be achieved after the requisite service period such as when an employee is eligible to retire or otherwise eligible to terminate employment before the end of the period in which a performance target could be achieved.[168] ASU 2014-12 provides that compensation cost should be recognized when it is probable that the performance target will be achieved.[169] The amount of compensation cost should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered.[170] If the performance target is met prior to the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period.[171]

ASU 2014-12 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015, with earlier adoption permitted.[172] An entity may elect to adopt the new standard on a prospective basis to all share-based payment awards that are granted or modified on or after the effective date.[173] Alternatively, an entity may elect to adopt the standard on a retrospective basis to all applicable awards that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter with the cumulative effect of applying the standard recognized as an adjustment to the opening retained earnings balance as of the beginning of the earliest annual period presented in the financial statements.[174]

5. Consolidated Collateralized Financing Entities

In August 2014, in response to an EITF consensus, the FASB issued ASU Update No. 2014-13,[175] which provides an alternative for how an entity that consolidates a collateralized financing entity ("CFE"), such as a collateralized debt

166. *Id.* at 1.
167. *Id.*
168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.*
172. *Id.* at 2.
173. *Id.*
174. *Id.*
175. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-13, Consolidation (Topic 810): Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity, a consensus of the FASB Emerging Issues Task Force (Aug. 2014) [hereinafter ASU 2014-13].

obligation or a collateralized loan obligation, measures the CFE's financial assets and financial liabilities.[176] ASU 2014-13 is intended to eliminate diversity in practice in the way in which entities account for any differences between the fair value of the CFE's financial assets and that of its financial liabilities.[177]

A CFE holds financial assets and issues beneficial interests in those financial assets that are classified as liabilities.[178] When an entity that consolidates a CFE accounts for the financial assets and liabilities at fair value, the fair value of the financial assets may differ from the fair value of the financial liabilities even when the financial liabilities have recourse only to the financial assets.[179]

ASU 2014-13 applies to an entity that consolidates a CFE under ASC Subtopic 810-10 if the entity measures the CFE's financial assets and financial liabilities at fair value based on other accounting guidance and the changes in the fair values of those financial assets and financial liabilities are reflected in its earnings.[180] It permits such an entity to use either the measurement guidance in ASU 2014-13 or in ASC Topic 820.[181] The measurement guidance in ASU 2014-13 provides that the entity should measure both the financial assets and the financial liabilities of the CFE using the more observable of the fair value of the financial assets and the fair value of the financial liabilities.[182] Any resulting net gains or losses reflected in the entity's consolidated earnings will be limited to changes in the fair value of the beneficial interests it holds, as well as compensation for services provided, which are measured under other applicable guidance.[183]

ASU 2014-13 is effective:

- For public business entities—for annual periods, and interim periods within those annual periods, beginning after December 15, 2015,[184] and
- For other entities—for annual periods ending after December 15, 2016, and interim periods beginning after December 15, 2016.[185]

Early adoption is permitted as of the beginning of an annual period.[186] An entity may elect to adopt the standard using either a modified retrospective approach, and recording a cumulative-effect adjustment to equity as of the beginning of the annual period of adoption, or a retrospective approach.[187]

176. *Id.* at 2.
177. *Id.* at 1.
178. *Id.* at 5.
179. *Id.* at 1.
180. *Id.*
181. *Id.* at 2.
182. *Id.*
183. *Id.* at 2–3.
184. *Id.* at 3.
185. *Id.*
186. *Id.*
187. *Id.*

6. Hybrid Financial Instruments

In November 2014, in response to an EITF consensus, the FASB issued ASU Update No. 2014-16,[188] which eliminates one of the alternative methods permitted under current GAAP for determining whether a share that is a host contract in a hybrid financial instrument is more akin to debt or equity.[189] ASU 2014-16 is intended to reduce the diversity in the accounting treatment for hybrid instruments resulting from the alternative methods and the diversity in practice with respect to the analysis of redemption features.[190]

A hybrid instrument is defined in the Master Glossary of the Codification as "[a] contract that embodies both an embedded derivative and a host contract."[191] When a class of shares has preferences and rights over other classes of shares, such as conversion rights, redemption rights, voting rights, and liquidation and dividend payment preferences, one or more of those features may meet the definition of a derivative.[192] ASU 2014-16 does not change the way in which an entity determines whether it must separate the embedded derivative in a hybrid financial instrument.[193] The amendments only clarify how an entity should evaluate the economic characteristics and risks related to the share, that is, the host contract, to determine whether the host contract is more akin to debt or equity.[194]

ASU 2014-16 requires an entity "to determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature on the basis of the relevant facts and circumstances."[195] No one term or provision by itself is determinative.[196] In this regard, the Summary in ASU 2014-16 states: "For example, the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract is not, in and of itself, determinative in the evaluation of whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument."[197] In evaluating the nature of the host contract, ASU 2014-16 states that the entity must consider:

- "the characteristics of the terms and features themselves (for example, contingent versus noncontingent, in-the-money versus out-of-the-money)";
- "the circumstances under which the hybrid financial instrument was issued or acquired (for example, issuer-specific characteristics, such as

188. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-16, Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity, a consensus of the FASB Emerging Issues Task Force (Nov. 2014) [hereinafter ASU 2014-16].

189. *Id.* at 2.

190. *Id.*

191. *Master Glossary, Accounting Standards Codification*, Fin. Acct. Standards Board, https://asc.fasb.org/glossary&letter=D (last visited Mar. 27, 2015).

192. ASU 2014-16, *supra* note 188, at 1.

193. *Id.* at 3.

194. *Id.*

195. *Id.* at 2.

196. *Id.*

197. *Id.*

whether the issuer is thinly capitalized or profitable and well-capitalized)"; and

- "the potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes."[198]

ASU 2014-16 is effective:

- For public business entities—for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015,[199] and
- For other entities—for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.[200]

Early adoption is permitted, including during an interim period as long as any adjustments are reflected as of the beginning of the fiscal year that includes that interim period.[201]

7. Pushdown Accounting

In November 2014, in response to an EITF consensus, the FASB issued ASU Update No. 2014-17,[202] which permits an acquired entity to use pushdown accounting in its separate financial statements after an event in which an acquirer obtains control of the acquired entity.[203] "Control," for purposes of ASU 2014-17, means ownership as defined in ASC paragraph 810-10-15-6,[204] which provides that control is the ownership of more than 50 percent of the outstanding voting shares of another entity or the power to control with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or court decree.[205] In pushdown accounting, the acquired entity uses the acquirer's basis in the preparation of its financial statements.[206]

The EITF examined this issue because GAAP did not have any guidance for the use of pushdown accounting, but the SEC required an entity to apply pushdown accounting after a transaction in which the entity became substantially

198. *Id.* at 3.
199. *Id.* at 4.
200. *Id.*
201. *Id.*
202. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-17, Business Combinations (Topic 805): Pushdown Accounting, a consensus of the FASB Emerging Issues Task Force (Nov. 2014) [hereinafter ASU 2014-17].
203. *Id.* at 1.
204. *Id.* at 5.
205. *ASC Subtopic 810-10, Consolidation—Overall*, Fin. Acct. Standards Board, ¶ 810-10-15-8, https://asc.fasb.org/section&trid=2197490 (last visited Apr. 27, 2015).
206. ASU 2014-17, *supra* note 202, at 12.

wholly owned, with certain exceptions.[207] On November 18, the SEC's Division of Corporation Finance and Office of the Chief Accountant (the "Staff") rescinded its guidance.[208] The Staff explained that its action was necessary to conform its guidance to ASU 2014-17.[209]

ASU 2014-17 provides that an acquired entity may apply pushdown accounting for the reporting period in which the change-in-control event occurred.[210] An acquired entity that elects to apply pushdown accounting would reflect in its separate financial statements the new basis of accounting established by the acquirer for the acquired entity's assets and liabilities under GAAP as of the acquisition date.[211] If the acquirer did not establish a new basis of accounting for the acquired entity's assets and liabilities because it was not required to do so by GAAP (such as when the acquirer is an investment company), the acquired entity may nevertheless still elect to apply pushdown accounting by reflecting in its separate financial statements the new basis of accounting that the acquirer would have applied if it had been subject to the GAAP requirement to apply a new basis of accounting for the acquired entity's assets and liabilities.[212]

The acquired entity that elects to apply pushdown accounting must recognize in its separate financial statements any acquisition-related liability incurred by the acquirer only if the liability represents an obligation of the acquired entity in accordance with other applicable GAAP.[213] In addition, the acquired entity must include in the notes to its financial statements various disclosures intended to enable users of its financial statements to evaluate the effect of pushdown accounting, including a qualitative description of the factors that make up the goodwill recognized.[214] If, in accounting for the acquisition of control, the acquiring entity recognizes any bargain purchase gains, however, the acquired entity may only recognize the gains as an adjustment to its additional paid-in capital.[215]

An acquired entity that does not elect to apply pushdown accounting for the reporting period in which the change-in-control occurred may elect to apply pushdown accounting in a subsequent reporting period.[216] When such an election is made, the acquired entity must describe the election as resulting in a change in accounting principle and comply with the GAAP applicable to a change in accounting principle.[217] The acquired entity must apply pushdown

207. *Id.* at 1.
208. SEC Staff Accounting Bulletin No. 115 (Nov. 18, 2014), *available at* http://www.sec.gov/interps/account/sab115.pdf.
209. *Id.* at 1.
210. ASU 2014-17, *supra* note 202, at 1.
211. *Id.* at 12.
212. *Id.*
213. *Id.* at 13.
214. *Id.* at 13–14.
215. *Id.* at 12–13.
216. *Id.* at 1.
217. *Id.* at 2.

accounting as of the acquisition date of the change-in-control, regardless of when the election is made.[218]

A subsidiary of an acquired entity may elect to apply pushdown accounting regardless of whether its parent, the acquired entity, elects to apply pushdown accounting.[219]

Whenever an entity determines to apply pushdown accounting, the decision is irrevocable.[220]

ASU 2014-17 was effective for both public and private entities with respect to any change-in-control event that occurred after November 18, 2014.[221] In addition, an entity can elect pushdown accounting for a change-in-control event that occurred before November 18, 2014, provided the event occurred within a reporting period for which financial statements have not yet been issued by the entity, unless the entity treats the election to apply pushdown accounting as a change in accounting principle.[222]

C. Private Company Council

In evaluating issues, the Private Company Council focuses on user-relevance and cost-benefit considerations for private companies given the framework for its deliberations articulated in the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies*.[223] Each of the PCC consensuses reached during 2014 was based on the PCC's evaluation of the costs and complexity of current GAAP and the usefulness of information presented in accordance with current GAAP to users of financial statements of private companies.

1. Goodwill

In January 2014, in response to a Private Company Council consensus, the FASB issued ASU Update No. 2014-02,[224] which permits a private company to elect to amortize goodwill over a period of ten years, unless the company can justify a period of less than ten years, and to test impairment using a simplified goodwill impairment test that will have to be conducted only when a triggering event occurs.[225] A private company is defined as a company other than a

218. *Id.* at 11.
219. *Id.*
220. *Id.*
221. *Id.* at 2.
222. *Id.*
223. Fin. Accounting Standards Bd., Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies 2, 8 (Dec. 23, 2013), *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176163703583&acceptedDisclaimer=true.
224. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-02, Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill, a consensus of the Private Company Council (Jan. 2014).
225. *Id.* at 2.

public business entity or not-for-profit entity, as defined in the Master Glossary of the Codification.[226]

ASU 2014-02 permits a private company to elect to amortize goodwill rather than test goodwill for impairment on an annual basis, as required by current GAAP, when the company applies "the acquisition method (as described in paragraph 805-10-05-4)," when it assesses "the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an investee when applying the equity method of accounting in accordance with Topic 323 on investments—equity method and joint ventures," and when it adopts "fresh-start reporting in accordance with Topic 852 on reorganizations."[227] Once the alternative to amortize goodwill is elected, the private company must also test impairment of goodwill at either an entity level or the reporting unit level when a triggering event occurs that indicates that the fair value of the entity or the reporting unit may be below its carrying amount.[228] In addition, it must apply this alternative to all existing goodwill and to all additions to goodwill resulting from future transactions within the scope of the accounting alternative.[229]

ASU 2014-02 is effective for fiscal years beginning after December 15, 2014, as well as for interim periods within those years; early adoption is permitted.[230]

2. Interest Rate Swaps

In January 2014, in response to a PCC consensus, the FASB issued ASU Update No. 2014-03,[231] which permits a private company to elect a simplified hedge accounting approach to account for interest rate swaps.[232] Under this approach, a private company's interest expense on its income statement would be the same as if the company had entered into a fixed-rate borrowing.[233]

ASU 2014-03 permits a private company to elect the alternative for a receive-variable, pay-fixed interest rate swap entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing provided the hedging relationship meets various conditions.[234] A private company may

226. A public business entity is defined in the Master Glossary of the Codification as including, among others, an entity that files financial statements with the SEC, has issued or intends to issue securities that are freely tradable and is required to prepare and make publicly available GAAP financial statements, or must file financial statements with a foreign or domestic regulatory agency. *See Master Glossary, Accounting Standards Codification*, Fin. Acct. Standards Board, https://asc.fasb.org/glossary&letter=D (last visited Mar. 27, 2015).

227. ASU 2014-02, *supra* note 224, at 7.

228. *Id.* at 8.

229. *Id.* at 7.

230. *Id.* at 4.

231. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-03, Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach, a consensus of the Private Company Council (Jan. 2014).

232. *Id.* at 1.

233. *Id.* at 2.

234. *Id.*

elect the simplified hedge accounting on a swap by swap basis, whether existing at the date of adoption of the alternative or entered into after that date.[235]

Under the simplified hedge accounting approach, an entity will be able to measure the swap at settlement value instead of fair value,[236] will be able to finalize the documentation supporting the hedge by the date on which the first annual financial statements are available to be issued after execution of the swap rather than concurrently with the execution of the swap,[237] and will be able to avoid certain fair value measurement disclosure requirements.[238]

ASU 2014-02 is effective for fiscal years beginning after December 15, 2014, as well as for interim periods within those years; early adoption is permitted.[239]

3. Consolidation

In March 2014, in response to a Private Company Council consensus, the FASB issued ASU Update No. 2014-07,[240] which permits a private company not to apply VIE accounting requirements for common control leasing arrangements when certain conditions are met.[241] GAAP requires an entity to consolidate a VIE when that reporting entity is considered to be the primary beneficiary of the VIE.[242] As a result, VIE requirements could, in certain circumstances, require a lessee to consolidate a lessor entity when both entities are under common control.[243]

ASU 2014-07 permits a private company lessee that is under common control with the lessor entity to elect not to consolidate the lessor entity when the arrangement between the private company lessee and the lessor entity meets certain conditions, which include that the leasing arrangement is substantially all of the activity between the companies.[244] Once elected, the private company must apply the alternative to all current and future lessor entities under common control that meet the requisite criteria to use the alternative.[245] ASU 2014-07 also provides that, rather than providing the VIE disclosures about the lessor entity, the private company lessee must disclose information about liabilities of the lessor entity and circumstances of the lessor entity that are not recognized in the lessor entity's financial statements "that expose the private company lessee to providing financial support to the lessor entity."[246]

235. *Id.* at 3.
236. *Id.* at 2.
237. *Id.* at 3.
238. *Id.*
239. *Id.*
240. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, a consensus of the Private Company Council (Mar. 2014).
241. *Id.* at 2.
242. *Id.* at 3.
243. *Id.* at 1.
244. *Id.* at 2.
245. *Id.*
246. *Id.*

ASU 2014-07 is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015; early adoption is permitted.[247]

4. Business Combinations

In December 2014, in response to a Private Company Council consensus, the FASB issued ASU Update No. 2014-18,[248] which permits a private company not to recognize the following on a separate basis from goodwill: (i) customer-related intangible assets, unless they are capable of being sold or licensed independently from the other assets of the business and (ii) noncompetition agreements.[249] Examples of customer-related intangible assets that will meet the condition that they are capable of being sold or licensed independently from the other assets of the business include mortgage servicing rights, commodity supply contracts, core deposits, and customer information such as names and contract information.[250]

ASU 2014-18 permits a private company to elect this accounting alternative whenever it must recognize or otherwise consider the fair value of intangible assets as a result of (i) "[a]pplying the acquisition method (as described in paragraph 805-10-05-4)," (ii) "[a]ssessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an investee when applying the equity method of accounting in accordance with ASC Topic 323 on investments—equity method and joint ventures," or (iii) "[a]dopting fresh-start reporting in accordance with Topic 852 on reorganizations."[251] A private company that elects this accounting alternative must also elect the accounting alternative in ASU 2014-02, relating to the amortization of goodwill over a ten-year period, and must apply the accounting alternative to all future transactions within the scope of the alternative.[252] A private company may not adopt the alternative for customer-related intangible assets and noncompetition agreements that exist as of the beginning of the period of adoption.[253]

The decision to adopt the accounting alternative must be made upon the occurrence of the first transaction within the scope of this accounting alternative that occurs in fiscal years beginning after December 15, 2015.[254] If the transaction occurs in the first fiscal year beginning after December 15, 2015, the adoption will be effective for that fiscal year and all periods thereafter.[255] If

247. *Id.*

248. Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-18, Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination, a consensus of the Private Company Council (Dec. 2014).

249. *Id.* at 1–2.

250. *Id.* at 8–9.

251. *Id.* at 7.

252. *Id.*

253. *Id.* at 2.

254. *Id.* at 3.

255. *Id.*

the transaction occurs in fiscal years beginning after December 15, 2016, the adoption will be effective in the interim period that includes the date of that first transaction and all periods thereafter.[256] Early adoption is permitted for any interim and annual financial statements that have not yet been made available for issuance.[257]

256. *Id.*
257. *Id.*

Caselaw Developments 2014[1]

Overview

Supreme Court. While reaffirming its commitment to the fraud-on-the-market presumption by which plaintiffs in a private Rule 10b-5 action can more easily prove classwide reliance on a misrepresentation, the Court held that defendants can attempt to rebut the presumption at the class certification stage by showing that the misrepresentation did not affect the price of the security the plaintiffs bought or sold.[2] In a case under the Securities Litigation Uniform Standards Act, the Court held that preclusion under that law—of state-law-based class actions involving asserted misrepresentations in the purchase or sale of securities traded on national exchanges ("covered securities")—did not reach to state-law-based suits against a bank that sold certificates of deposit ("CDs"), where the CDs were not covered securities but the alleged misrepresentation concerned the bank's investment in covered securities.[3]

SEC rulemaking. The D.C. Circuit largely rejected a challenge to the regulations adopted by the Securities and Exchange Commission ("SEC" or "Commission") to implement the conflict minerals reporting requirement imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act—even though the SEC acknowledged in its adopting release that it could not quantify the benefits from the regulation.[4]

Rule 10b-5 primary violations. The Fourth Circuit held that the Supreme Court's interpretation of Rule 10b-5(b) in its *Janus* decision does not apply in criminal cases.[5] The Eleventh Circuit avoided application of *Janus* in an SEC enforcement action on the reasoning that the case depended on Rule 10b-5(a) and (c), and found that the defendants could be primary violators under those subsections.[6]

Insider trading. The Second Circuit held that insider trading proscriptions derived from Rule 10b-5 apply to trading in private company stock.[7] The Third

1. The caselaw developments section covers opinions decided during the calendar year 2014. Where this portion of the annual review expresses opinions, those opinions 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.

2. *See infra* notes 29–60 and accompanying text.

3. *See infra* notes 61–69 and accompanying text.

4. *See infra* notes 70–108 and accompanying text.

5. *See infra* notes 131–41 and accompanying text.

6. *See infra* notes 142–46 and accompanying text.

7. *See infra* notes 157–67 and accompanying text.

Circuit found that the SEC had authority to adopt Rule 10b5-2, which sets out relationships of trust and confidence sufficient to generate a duty to the source of information, such that the violation of that duty can support an insider trading case based on the misappropriation theory.[8] The Second Circuit held that tippee liability requires that the tippee know that the tipper received some personal benefit from making the tip.[9]

Remedies in enforcement actions. The Second Circuit affirmed disgorgement from a fund manager of money that his fund made through trades that he directed using inside information—even though the manager did not personally pocket the fund profits and even though the court had held in a previous decision that the fund manager could not be forced to pay the fund's profits through restitution in his related criminal case.[10] The Third Circuit affirmed a multimillion dollar disgorgement in a case where the SEC successfully claimed the defendant had violated section 13(d).[11] The Second Circuit found that a district court judge abused his discretion in refusing to approve a settlement that the SEC had negotiated in a civil enforcement action.[12]

Disclosure of drug testing results and prospects for FDA approval. The Sixth Circuit found no strong inference of scienter where the alleged facts showed that a device company released positive results from analyzing a modified intent-to-treat population but the Food and Drug Administration ("FDA") later criticized use of that population and declined to approve the device.[13] The Third Circuit found that plaintiffs did not plead falsity of a statement that a drug company was proceeding to Phase III testing based on the totality of information available to it, including an interim look at Phase II—even though the final analysis of Phase II later showed that the drug was not efficacious.[14] The First Circuit found no strong inference of scienter where a company made positive statements about the possibility for approval of a biologic without immediately disclosing negative observations that the FDA provided in a Form 483 and without disclosing failures of bioreactors at two production facilities.[15]

Duty to disclose. The Second Circuit found a duty to disclose ongoing environmental violations created by an issuer's detailed descriptions in prospectuses of its efforts to comply with environmental laws.[16] The Eleventh Circuit found that evidence provided to a jury was sufficient for the jury to find that a company had a duty to disclose—when it repurchased stock from a departing employee—that the company was then in negotiations for a merger, with the duty based largely on the company's history of assuring employees that it would continue to be

8. *See infra* notes 168–84 and accompanying text.
9. *See infra* notes 185–208 and accompanying text.
10. *See infra* notes 212–29 and accompanying text.
11. *See infra* notes 230–63 and accompanying text.
12. *See infra* notes 264–78 and accompanying text.
13. *See infra* notes 283–97 and accompanying text.
14. *See infra* notes 298–321 and accompanying text.
15. *See infra* notes 322–50 and accompanying text.
16. *See infra* notes 355–82 and accompanying text.

majority-owned by the founding family.[17] The Ninth Circuit held that Item 303(a)(3)(ii) does not create a duty to disclose, the violation of which is actionable under Rule 10b-5.[18]

Misleading representation. The Fifth Circuit found that use of the term "reserves" could mislead where the issuer did not use that term in the technical manner common in the oil and gas industry.[19]

Materiality. The Tenth Circuit found immaterial both alleged omissions about a hedging strategy and alleged omissions about a CEO's ability to meet margin calls on loans secured by his company stock.[20]

Scienter. The Sixth Circuit set out its framework for analyzing the scienter of an entity defendant and found the issuer's scienter inadequately alleged.[21] The Ninth Circuit reversed dismissal of a case in large part because the plaintiffs pled that the truth was imputed to executives through that circuit's "core operations" analysis.[22]

Loss Causation. The Second Circuit held that a 2012 announcement could serve as corrective for a fraud that occurred in 2007–2009, even though the issuer had published unchallenged information on the same subject from 2009 to 2012.[23] The Fifth Circuit held that a series of disclosures could collectively be corrective even though some of them, considered individually, did not sufficiently suggest falsity to constitute a correction for loss causation purposes.[24] The Ninth Circuit held that loss causation pleading must meet the standard in Rule 9(b).[25]

Extraterritoriality. The Second Circuit held that Rule 10b-5 did not cover swaps—even though the plaintiffs entered into the swaps in this country—because the referenced security was traded on a foreign exchange and the defendants who made the allegedly false statements were in another country.[26]

Supreme Court

In 2014, the Supreme Court handed down two securities cases. In one, the Court declined to abandon the fraud-on-the-market reliance presumption but held that a defendant may, in opposing certification of a Rule 23(b)(3) class, seek to rebut that presumption by proof that the alleged misrepresentations on which the plaintiff sues did not affect the market price for the security that the plaintiff bought or sold.[27] In the other decision, the Court held that the Securities Litigation Uniform Standards Act—which precludes class action lawsuits

17. *See infra* notes 383–98 and accompanying text.
18. *See infra* notes 399–448 and accompanying text.
19. *See infra* notes 451–62 and accompanying text.
20. *See infra* notes 463–80 and accompanying text.
21. *See infra* notes 487–511 and accompanying text.
22. *See infra* notes 512–45 and accompanying text.
23. *See infra* notes 550–57 and accompanying text.
24. *See infra* notes 558–75 and accompanying text.
25. *See infra* notes 576–79 and accompanying text.
26. *See infra* notes 580–96 and accompanying text.
27. *See infra* notes 29–60 and accompanying text.

that are based on state statutes or state common law and involve alleged misrepresentations in the purchase or sale of "covered securities"—did not preclude state-law-based claims of misrepresentations in the sale of certificates of deposit (which were not "covered securities"), even though plaintiffs alleged that the defendant bank misrepresented that the CDs were safe *because* the bank was buying "covered securities."[28]

Efficient Market and Class Certification

Most securities class actions proceed under Rule 23(b)(3) of the Federal Rules of Civil Procedure. To certify a class under that rule, a "court [must] find[] that the questions of law or fact common to class members predominate over any questions affecting only individual members."[29] When a private plaintiff sues under Rule 10b-5, the plaintiff must prove reliance on a false or misleading statement or on an omitted material fact that the defendant was required to disclose but did not.[30] A federal court will be unable to certify a Rule 23(b)(3) class based on a misrepresentation if each class member must prove that he or she read or heard and then relied on the misrepresentation because, in that case, "individual issues . . . would . . . overwhelm[] the common ones."[31] In 1988, the Supreme Court adopted the fraud-on-the-market presumption by which a court presumes that each member of a plaintiff class indirectly relied on a misrepresentation if the security the plaintiffs bought or sold traded in a market that was efficient in the sense that the market price impounded new information.[32] That presumption, unless rebutted, renders reliance amenable to class-wide proof and so permits certification of Rule 23(b)(3) classes in Rule 10b-5 cases.[33]

In the last three years, the Supreme Court has wrestled with the application of this presumption. A private Rule 10b-5 plaintiff must, in addition to proving reliance, prove that any misrepresentation on which the case rests was material (materiality) and that the misrepresentation caused the plaintiff loss (loss causation).[34] In 2011, the Court held that a plaintiff need not prove loss causation in order to win certification of a Rule 23(b)(3) class, because "[l]oss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock."[35] Thus, "[t]he fact that a

28. *See infra* notes 61–69 and accompanying text.
29. Fed. R. Civ. P. 23(b)(3).
30. Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988) (interpreting 17 C.F.R. § 240.10b-5).
31. *Id.* at 242.
32. *Id.* at 243–47 (plurality opinion). "Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." *Id.* at 246 (footnote omitted). "With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price." *Id.* at 244 (quoting *In re* LTV Sec. Litig., 88 F.R.D. 134, 143 (N.D. Tex. 1980)).
33. *See* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2185 (2011) [hereinafter *Halliburton I*].
34. *Id.* at 2184.
35. *Id.* at 2186.

subsequent loss may have been caused by factors other than the revelation of a misrepresentation [which is the question that loss causation addresses] has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory."[36] In 2013, the Court held that a Rule 10b-5 plaintiff need not prove materiality in order to win a Rule 23(b)(3) certification because—although materiality is "indisputably" "an essential predicate of the fraud-on-the-market theory"—materiality depends on whether the omitted or misrepresented fact would be significant to a reasonable investor and hence "can be proved through evidence common to the class."[37] Thus, "there is no risk whatever that a failure of proof on the common question of materiality will result in individual questions predominating," but instead "failure to present sufficient evidence of materiality to defeat a summary-judgment motion or to prevail at trial . . . would end the case for one and for all."[38]

Last year, the Court published the third of its recent fraud-on-the market trilogy: *Halliburton Co. v. Erica P. John Fund, Inc*.[39] The decision includes two principal holdings.

First, the Court declined to abandon the fraud-on-the market presumption altogether.[40] While the majority[41] acknowledged "studies purporting to show that 'public information is often not incorporated immediately (much less rationally) into market prices,'"[42] it rejected the notion that fraud-on-the-market theory presupposes a showing that a market for a particular security is *always* efficient.[43] Instead, that theory, as the majority saw it, lives easily with the reality that "[t]he markets for some securities are more efficient than the markets for others, and even a single market can process different kinds of information more or less efficiently, depending on how widely the information is disseminated and how easily it is understood."[44] Even the critics of the efficient-capital-market hypothesis, however, "acknowledge that public information generally affects stock prices."[45] To Halliburton's argument that value investors buy securities based on analysis suggesting to them that the market has undervalued those securities and thereby do *not* rely on the price to transmit information, the majority responded that the fraud-on-the-market theory rests on the "reasonable . . .

36. *Id.*

37. Amgen Inc. v. Conn. Ret. Plans & Trust Fund, 133 S. Ct. 1184, 1195 (2013).

38. *Id.* at 1196.

39. 134 S. Ct. 2398 (2014) [hereinafter *Halliburton II*].

40. *Id.* at 2408–13. The Court held that it could overturn *Basic*, "a long-settled precedent," only if it found a "'special justification,' not just an argument that the precedent was wrongly decided." *Id.* at 2407 (citation omitted).

41. Chief Justice Roberts' opinion was joined by Justices Kennedy, Ginsburg, Breyer, Sotomayor, and Kagan. In an opinion concurring in the judgment, Justices Scalia, Thomas, and Alito disagreed, arguing that "[l]ogic, economic realities, and our subsequent jurisprudence have undermined the foundations of the [fraud-on-the-market] presumption, and *stare decisis* cannot prop up the façade that remains." *Id.* at 2418 (Thomas, J., concurring).

42. *Id.* at 2409 (quoting Brief for Petitioner at 17, Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014) (No. 13-317), 2013 WL 6907610, at *17).

43. *Id.*

44. *Id.*

45. *Id.* at 2410.

presum[ption] that *most* investors—knowing that they have little hope of outperforming the market in the long run based solely on their analysis of publicly available information—will rely on the security's market price as an unbiased assessment of the security's value in light of all public information."[46] Moreover, in the Court's view, even the value investor who buys thinking that the market does not *currently* incorporate information into a proper price relies on the market to *eventually* incorporate information into a corrected price.[47]

The original 1988 opinion recognized that the fraud-on-the-market presumption could be rebutted by "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff."[48] In its 2013 decision, the Court acknowledged that "market efficiency and the public nature of the alleged misrepresentations must be proved before a securities-fraud class action can be certified."[49] The 2014 *Halliburton* decision's second important holding establishes the relationship—at the class certification stage—between (i) the requirement that the plaintiff can invoke the fraud-on-the-market presumption only by proving the efficiency of the market in which the relevant security trades, and (ii) evidence that the particular misrepresentation on which the plaintiff sues did or did not impact the price of the security when the plaintiff bought.[50] The majority held that the plaintiff does not, in order to win certification, have to prove the "price impact" of the particular misrepresentation, as that requirement would effectively require the plaintiff to prove a presumed fact.[51] On the other hand—and consistent with the majority's observation that a market that is generally efficient may not efficiently incorporate a specific piece of information into a security's price[52]—a defendant has a right at the class certification stage to *rebut* the fraud-on-the-market presumption as it applies to the *particular* misrepresentation in the case by showing that *that* misrepresentation had no "price impact."[53] The majority reasoned that, otherwise, the rebuttable presumption indirectly positing that the price reflects the misstatement could control the class certification decision simply because the court refused to look at direct evidence disproving that connection.[54]

Significance and analysis. Practically, *Halliburton* means that a plaintiff will seek to prove that the market for a particular security was *generally* efficient by, for example, submitting "an event study of various episodes that might have been expected to affect the price of [the security at issue], in order to demonstrate that the market for that stock takes account of material, public information

46. *Id*. at 2411 (emphasis added by the Court in *Halliburton II*) (quoting Amgen Inc. v. Conn. Ret. Plans & Trust Fund, 133 S. Ct. 1184, 1192 (2013)).
47. *Id*.
48. Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988).
49. *Amgen*, 133 S. Ct. at 1199.
50. *Halliburton II*, 134 S. Ct. at 2413–17.
51. *Id*. at 2414.
52. *Id*. at 2410 (observing that "[m]arket efficiency is a matter of degree and accordingly . . . a matter of proof").
53. *Id*. at 2414–17.
54. *Id*. at 2415–16.

about the company."[55] The defendant may submit evidence—such as a different event study—to show that the market was not *generally* efficient. The plaintiff has the burden of showing general efficiency.[56] But, even if the plaintiff succeeds in winning the battle over *general* market efficiency, the defense can still defeat certification by proving that the *particular* misrepresentation on which the plaintiff has sued did not affect the security's price.[57] The defendant may do so either by showing that the misstatement did not affect the security's price at the time the defendant made the misstatement or by showing that the correction of the misstatement did not affect the price.[58]

Analytically, the Court's difficulty in its 2011, 2013, and 2014 cases derives from the circumstance that the same econometric evidence, principally through event studies, can show materiality, loss causation, reliance, and damages.[59] So, as the Court wandered through its trio of fraud-on-the-market decisions, it found the elements related at the level of econometric proof, even though they remained distinct at the level of legal analysis. Thus, a defendant cannot, under the Court's 2011 and 2013 decisions, offer "price impact" evidence to oppose a motion to certify a Rule 23(b)(3) class on the ground that the evidence shows that the misrepresentation was not material or on the ground that the misrepresentation did not cause loss, but can, under the 2014 decision, offer the same evidence to oppose the same motion as rebuttal to reliance.[60]

55. *Id.* at 2415.

56. *Id.* at 2412 ("The *Basic* presumption does not relieve plaintiffs of the burden of proving—before class certification—that [the Rule 23(b)(3) predominance] requirement is met. *Basic* instead establishes that a plaintiff satisfies that burden by proving the prerequisites for invoking the presumption—namely, publicity, materiality, market efficiency, and market timing. The burden of proving those prerequisites still rests with plaintiffs and (with the exception of materiality) must be satisfied before class certification.").

57. *Id.* at 2415.

58. *Id.* at 2414 ("*Basic* itself made clear that the presumption was just that, and could be rebutted by appropriate evidence, including evidence that the asserted misrepresentation (or its correction) did not affect the market price of the defendant's stock." (internal quotation marks omitted)). The majority seems to assume that the defendant must carry the burden of persuading the court that the misstatement did not affect the security's price rather than that the defendant's presentation of some evidence to that effect shifts to the plaintiff the burden of showing that the misstatement did affect the price. *But see* FED. R. EVID. 301 ("In a civil case, unless a federal statute or these rules provide otherwise, the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption. But this rule does not shift the burden of persuasion, which remains on the party who had it originally.").

59. *See* William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 874–83 (2005).

60. *See Halliburton II*, 134 S. Ct. at 2416–17. The Court did not dilate on how to prove that a market is efficient. In a post-*Halliburton II* case, the Eleventh Circuit did. Local 703, I.B. of T. Grocery & Food Emps. Welfare Fund v. Regions Fin. Corp., 762 F.3d 1248 (11th Cir. 2014). Specifically, the Eleventh Circuit rejected the defendants' argument that the district court, in evaluating market efficiency on a motion to certify a class, was obliged to consider each of the factors set out in *Cammer*. *Id.* at 1255–56 (discussing Cammer v. Bloom, 711 F. Supp. 1264 (D.N.J. 1989)).

Securities Litigation Uniform Standards Act ("SLUSA")

SLUSA defines a "covered class action" as a lawsuit brought on behalf of more than fifty persons.[61] SLUSA requires that covered class actions be based on federal securities law and proceed in federal court if plaintiffs allege a misrepresentation or "omission of a material fact in connection with the purchase or sale of a covered security"—essentially a security listed on a national exchange.[62] SLUSA forbids—in a covered class action, whether brought in federal or state court—claims for fraud in the purchase or sale of a "covered security" where the claims rest on state common or statutory law.[63] If plaintiffs file a covered class action in state court—asserting state law claims based on misrepresentations or omissions in the purchase or sale of a "covered security"—defendants can remove the case to federal court.[64] The federal court should then dismiss the case if it is precluded by SLUSA.[65]

In *Chadbourne & Parke LLP v. Troice*, the Supreme Court considered whether SLUSA applied to cases brought in state court, asserting state law claims, in which the plaintiffs alleged that they purchased CDs that were not "covered securities," based on misrepresentations that the bank issuing the CDs held, or would hold, "covered securities" which made investments in the CDs more secure.[66] The Court read the critical phrase—limiting SLUSA to cases in which plaintiffs allege a "misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security"[67]—to restrict the statute to actions in which plaintiffs allege that the misrepresentation or omission "is material to a decision by one or more individuals (other than the fraudster) to buy or sell a 'covered security.'"[68] Because the plaintiffs asserted only "misrepresentations

61. 15 U.S.C. §§ 77p(f)(2)(A)(i), 78bb(f)(5)(B)(i) (2012).

62. *Id.* § 77p(b)–(d), (f)(1)–(3); *see id.* § 77r(b) (defining "covered security"); *id.* § 78bb(f)(5)(E) (same).

63. *Id.* §§ 77p(b), 78bb(f)(1).

64. *Id.* §§ 77p(c), 78bb(f)(2).

65. Kircher v. Putnam Funds Trust, 547 U.S. 633, 643 (2006) ("§ 77p(c) 'provides that any class action described in Subsection (b) that is brought in a State court shall be removable to Federal district court, and may be dismissed pursuant to the provisions of subsection (b).'" (quoting S. Rep. No. 105-182, at 8 (1998)); *id.* at 644 ("[I]f the action is precluded, neither the district court nor the state court may entertain it, and the proper course is to dismiss."); Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 87 (2006) ("[SLUSA] denies plaintiffs the right to use the class-action device to vindicate certain [state-law] claims.").

66. 134 S. Ct. 1058, 1065 (2014).

67. *Id.* at 1066 (quoting 15 U.S.C. § 78bb(f)(1)(A) (2012)).

68. *Id.* The Court reached this decision for five reasons. First, SLUSA "focuses upon transactions in covered securities, not upon transactions in uncovered securities." *Id.* Second, the critical phrase "suggests a connection that matters" between the fraud and the purchase or sale of the covered security, and "a connection matters where the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security, not to purchase or to sell an uncovered security, something about which the Act expresses no concern." *Id.* Third, "every securities case in which this Court has found a fraud to be 'in connection with' a purchase or sale of a security has involved victims who took, who tried to take, who divested themselves of, who tried to divest themselves of, or who maintained *an ownership interest* in financial instruments that fall within the relevant statutory definition." *Id.* Fourth, the Securities Act of 1933 and the Securities Exchange Act of 1934 "underlying" SLUSA "refer to persons engaged in securities transactions that lead to the taking or dissolving of ownership positions," and evince no purpose "to protect persons whose connection with

about the *Bank's* ownership of covered securities—fraudulent assurances that the Bank owned, would own, or would use the victims' money to buy *for itself* shares of covered securities"—the state court allegations did not fall within that limited reach.[69]

Courts of Appeals

SEC Rulemaking

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") required the SEC to adopt a regulation imposing a conflict minerals reporting requirement on public companies.[70] The Commission adopted the regulation.[71] In 2014, the D.C. Circuit affirmed in part and reversed in part a district court order granting summary judgment to the SEC in a suit brought by the National Association of Manufacturers ("NAM") challenging that regulation.[72]

The Dodd-Frank Act defined "conflict minerals" to include (i) "columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives," and (ii) "any other mineral or its derivatives determined by the Secretary of State to be financing conflict in the Democratic Republic of the Congo or an adjoining country," each a "covered country."[73] Congress required the SEC to issue rules requiring elaborate investigation and reporting by public companies on conflict minerals used in their products.[74]

The SEC regulation sets out a three-step process.[75] First, a public company must determine whether conflict minerals are "necessary to the functionality or production of a product manufactured by the [company] or contracted by [the company] to be manufactured."[76] If the company finds this to be so,[77] then it must proceed to the second step, which requires a reasonable inquiry to determine whether the conflict minerals are from a covered country or

the statutorily defined securities is more remote than words such as 'buy,' 'sell,' and the like, indicate." *Id.* at 1067. "Fifth, to interpret the necessary statutory 'connection' more broadly than [did the Court] would interfere with state efforts to provide remedies for victims of ordinary state-law fraud." *Id.* at 1068.

69. *Id.* at 1071. The defendants in the state cases removed the state court lawsuits to federal court, where a district court judge dismissed the actions. *Id.* at 1065. The Fifth Circuit reversed that dismissal, and the Supreme Court affirmed that reversal. *Id.* at 1065, 1072.

70. Pub. L. No. 111-203, § 1502, 124 Stat. 1376, 2213 (2010) (codified at 15 U.S.C. § 78m(p) (2012)).

71. Conflict Minerals, 77 Fed. Reg. 56274 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts 240 & 249b).

72. Nat'l Ass'n of Mfrs. v. SEC, 748 F.3d 359, 373 (D.C. Cir. 2014), *overruled in part by* Am. Meat Inst. v. U.S. Dep't of Agric., 760 F.3d 18, 22–23 (D.C. Cir. 2014) (en banc).

73. Dodd-Frank Act § 1502(e)(4), 15 U.S.C. § 78m(p)(5) (2012).

74. Dodd-Frank Act § 1502(b), 15 U.S.C. § 78m(p)(1) (2012).

75. Conflict Minerals, 77 Fed. Reg. at 56279 ("We are adopting a three-step process, as proposed, but some of the mechanisms within the three steps have been modified in response to comments.").

76. *Id.* at 56362 (to be codified at 17 C.F.R. § 240.13p-1).

77. If the company does not use, or contract for the manufacture of, conflict minerals in this way, then "the issuer is not required to take any action, make any disclosures, or submit any reports." *Id.* at 56279.

from recycled or scrap sources, with this investigation called a reasonable country of origin inquiry or "RCOI."[78] If the company determines through its RCOI that (i) the conflict minerals do not originate in a covered country, or (ii) the company has no reason to believe that the minerals originate in a covered country, or (iii) the minerals it uses come from scrap or recycling, then the company must file a Form SD describing its RCOI and its determinations.[79]

If, through the RCOI, the company (i) knows that the minerals originated in a covered country and do not come from scrap or recycled sources, or (ii) has reason to believe that the minerals may have originated in a covered country and has reason to believe the minerals may not have come from scrap or recycled sources, then the company must to proceed to step three.[80] In step three, the company must perform "due diligence on the source and chain of custody of its conflict mineral . . . [,] conform[ing that investigation] to a nationally or internationally recognized due diligence framework, if such a framework is available for the conflict mineral."[81] If the company determines from its due diligence investigation that the minerals do not originate in a covered country or that the minerals are from scrap or recycled sources, then the company must (i) file a Form SD containing this conclusion and describing the RCOI and the due diligence investigation in a portion of the Form SD under the heading "Conflicts Minerals Disclosure," and (ii) disclose this information on its website.[82] Otherwise, the company must file a Conflict Minerals Report ("CMR") which must include not only a description of the RCOI and the due diligence investigation but also the report of an independent private sector audit conducted in accordance with standards established by the Comptroller General of the United States, expressing an opinion as to whether the due diligence investigation was conducted in accordance with any nationally or internationally recognized due diligence framework.[83] The CMR must also include—for any relevant products that are not "DRC conflict free" (i.e., for which the conflict minerals necessary to their manufacture or functionality do not directly or indirectly benefit "armed groups" perpetrating serious human rights violations in the covered countries, such groups identified in the annual Country Reports on Human Rights Practices)—"a description of those products, the facilities used to process the necessary conflict minerals in those products, if known, the country of origin of the necessary conflict minerals in those products, if known, and the efforts to determine the mine or location of origin with the greatest possible specificity . . . ."[84]

78. *Id.* at 56362–63 (Item 1.01(a) of Form SD) (noting that Form SD will not appear in the Code of Federal Regulations); *see also id.* at 56283 (charting a registrant's analytical framework).

79. *Id.* at 56363 (Item 1.01(b) of Form SD).

80. *Id.* (Item 1.01(c) of Form SD).

81. *Id.* (Item 1.01(c) of Form SD).

82. *Id.* (Item 1.01(c) of Form SD).

83. *Id.* (Item 1.01(c)(1) of Form SD).

84. *Id.* at 56364 (Item 1.01(c)(2) of Form SD); *see id.* (Item 1.01(d)(2), (4) of Form SD) (defining "armed group" and "DRC conflict free"). The regulation provides a phase-in temporary period of two years for large companies and four years for smaller companies, during which companies are not required to submit an audit report with respect to any products that are "DRC conflict undeterminable."

The company must attach its CMR to its Form SD and make the CMR available on its website.[85]

In requiring disclosure regarding conflict minerals, Congress expressed its "sense . . . that the exploitation and trade of conflict minerals originating in the Democratic Republic of the Congo is helping to finance conflict characterized by extreme levels of violence in the eastern Democratic Republic of the Congo, particularly sexual- and gender-based violence, and contributing to an emergency humanitarian situation therein, warranting [a new disclosure rule]."[86] The SEC estimated the initial aggregate compliance costs with its rule at between $3 and $4 billion, and estimated ongoing annual aggregate compliance costs at between $207 million and $609 million.[87] The SEC stated that it could not estimate the rule's benefits.[88] Just as it was unable to estimate benefits overall, the Commission said that it was not able to estimate quantitatively benefits resulting from any of the decisions it made in formulating the rule, but could only provide a "qualitative" discussion.[89]

The D.C. Circuit rejected NAM's argument that the SEC's admission that it had not measured benefits showed that the agency had failed to conduct the kind of cost/benefit analysis that the Exchange Act mandates.[90] The appellate court held that the SEC was not required to quantify benefits because "the rule's benefits would occur half-a-world away in the midst of an opaque conflict

Id. (Instruction (2) to Item 1.01 of Form SD); *see id.* (Item 1.01(d)(5) of Form SD) (defining "DRC conflict undeterminable").

85. *Id.* at 56363 (Item 1.01(c) of Form SD).

86. Dodd-Frank Act § 1502(a), 15 U.S.C. § 78m note (2012).

87. Conflict Minerals, 77 Fed. Reg. at 56353–54.

88. The Commission wrote:

> Congress intended for the rule issued pursuant to Section 1502 to decrease the conflict and violence in the DRC, particularly sexual and gender based violence. A related goal of the statute is the promotion of peace and security in the Congo. These are compelling social benefits, which we are unable to readily quantify with any precision, both because we do not have the data to quantify the benefits and because we are not able to assess how effective Section 1502 will be in achieving those benefits. We also note that these objectives of Section 1502 appear to be directed at achieving overall social benefits and are not necessarily intended to generate measurable, direct economic benefits to investors or issuers specifically. Additionally, the social benefits are quite different from the economic or investor protection benefits that our rules ordinarily strive to achieve. We therefore have not attempted to quantify the benefits of the final rule.

Id. at 56350 (footnotes omitted); *see also id.* at 56335 ("We also note that these objectives of Section 1502 do not appear to be those that will necessarily generate measurable, direct economic benefits to investors or issuers.").

89. *Id.* at 56342 ("We are unable to quantify the impact of each of the decisions we discuss below with any precision because reliable, empirical evidence regarding the effects is not readily available to the Commission, and commentators did not provide sufficient information to allow us to do so. Thus, in this section, our discussion on the costs and benefits of our individual discretionary choices is qualitative.").

90. Nat'l Ass'n of Mfrs. v. SEC, 748 F.3d 359, 369 (D.C. Cir. 2014) (referring to "15 U.S.C. § 78w(a)(2), [under which] the Commission 'shall not adopt any rule [under 15 U.S.C. § 78m(p)] . . . which would impose a burden on competition not necessary or appropriate' to advance the purposes of securities laws [and 15 U.S.C. § 78c(f), providing that] . . . when the Commission 'is engaged in rulemaking,' it must 'consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation'").

about which little reliable information exists, and concern a subject about which the Commission has no particular expertise."[91] The court then commented that, even if the SEC had been able to "estimate how many lives are saved or rapes prevented as a direct result of the final rule, doing so would be pointless because the costs of the rule—measured in dollars—would create an apples-to-bricks comparison."[92] Most importantly, the court recognized that "[d]espite the lack of data, the [SEC] *had* to promulgate a disclosure rule" because Congress commanded the agency to do so, and therefore the SEC could rely—for cost/benefit analysis—on the congressional "'determin[ation] that [the rule's] costs were necessary and appropriate in furthering the goals' of peace and security in the Congo."[93]

The court also rejected NAM's more particular complaints that the SEC—in crafting the details of the new rule—acted arbitrarily and capriciously within the meaning of the Administrative Procedure Act.[94] To NAM's objection that the Commission failed to include a *de minimus* exception, the court responded that the SEC's reasoning—that, because conflict minerals "are often used in products in very limited quantities," such an exception "would be contrary to the [statute] and Congressional purpose"[95]—bore "'a rational connection' to the facts."[96] To NAM's objection that the threshold for proceeding to the third step was too low, the court answered that, because the statute was silent on that standard, the SEC rightly used its authority to "fill [the] gap[]"[97] and that, in setting the trigger at a reason to believe that the conflict minerals may have originated in covered countries, the Commission "did not go as far as it might have, [as] it declined to require due diligence by issuers who encounter no red flags in their inquiry" and therefore reduced costs and avoided "a flood of trivial information."[98]

NAM offered a technical argument that the rule violated the statute by extending the RCOI and due diligence burdens to companies that *contracted for products* to be manufactured where the functionality of those products or their manufacture required conflict minerals.[99] The court concluded that, because the statute required a CMR including "a description of the products manufactured *or contracted to be manufactured* that are not DRC conflict free,"[100] the SEC could extend the inquiry burdens to companies contracting for the manufacture of

91. *Id.*
92. *Id.*
93. *Id.* (quoting Conflict Minerals, 77 Fed. Reg. at 56350).
94. *Id.* at 365–69; *see* 5 U.S.C. § 706(2) (2012) (providing that a court must "hold unlawful and set aside agency action . . . found to be[ ] arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law [, or] in excess of statutory jurisdiction").
95. *NAM*, 748 F.3d at 365–66 (quoting Conflict Minerals, 77 Fed. Reg. at 56298). The court added that the SEC "relying on text, context, and policy concerns, inferred that Congress wanted the disclosure regime to work even for . . . small uses" and that a "*de minimus* exception would, in the Commission's judgment, 'thwart' that goal." *Id.* at 365.
96. *Id.* at 366 (quoting Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)).
97. *Id.*
98. *Id.* at 367.
99. *Id.* at 367–68.
100. Dodd-Frank Act § 1502(b), 15 U.S.C. § 78m(p)(1)(A)(ii) (2012) (emphasis added).

conflict mineral-tainted products even though the statute expressly mandated inquiry by only companies for which "conflict minerals are necessary to the functionality or production of a product manufactured by such [companies]," without referring to contracted-for products.[101] The court could "not understand how an issuer could describe its contracted-for products without first conducting due diligence on those products, or why the statute would require certain products to be described in a report without a corresponding explanation of the related due diligence efforts."[102] The D.C. Circuit held that the Commission's extension of the inquiry burden did not violate the statute but "reconcile[d] otherwise confusing and conflicting provisions."[103] Moreover, the extension was not arbitrary or capricious because, without it, companies might try to "'avoid [the rule] by contracting out the manufacture' of their products."[104]

The only portion of the rule that the D.C. Circuit panel struck down was the portion requiring a company filing a CMR to identify products as not "DRC Conflict Free."[105] The court held that "[b]y compelling an issuer to confess blood on its hands, the statute interferes with [the] exercise of . . . freedom of speech under the First Amendment."[106] But the circuit, en banc, later repudiated that holding in a case challenging country-of-origin labeling for food products, with the en banc opinion adopting an analytical framework that has generated additional briefing in the conflict minerals case.[107]

Significance and analysis. In 2011, the SEC took a beating on the cost/benefit analysis underlying its shareholder proxy access rule.[108] Counterintuitively, the Commission fared better with its conflict minerals rule when the SEC simply threw up its hands and proclaimed that it could not even estimate what, if any, benefits the rule would produce. True enough, as the appellate court expressly recognized, the SEC could hardly (at least absent risking a constitutional crisis) avoid adopting a rule that Congress required the agency to produce. But the notion that a seventy-two word "sense of Congress" can justify imposition of billions of dollars in costs on public companies precisely because the implementing agency has no expertise in estimating humanitarian and social outcomes suggests that such a brief statement

101. *NAM*, 748 F.3d at 363, 368; *see* 15 U.S.C. § 78m(p)(2)(B) (2012).

102. *NAM*, 748 F.3d at 368.

103. *Id.*

104. *Id.* (quoting Conflict Minerals, 77 Fed. Reg. at 56291). The circuit court also rejected NAM's objection to the SEC's longer phase-in period for smaller public companies than for larger companies, holding that this difference was neither arbitrary nor capricious because, as "the Commission explained, [larger issuers] can exert greater leverage to obtain information about their conflict minerals, and they may be able to exercise that leverage indirectly on behalf of small issuers in their supply chains." *Id.* (citing Conflict Minerals, 77 Fed. Reg. at 56322–23 & n.570).

The court supported all its holdings against the Administrative Procedure Act challenges with more general reasoning harkening back to the unquantified benefits implied by the Sense of Congress statement in the Dodd-Frank Act. *Id.* at 370.

105. *Id.* at 370–73.

106. *Id.* at 371.

107. Am. Meat Inst. v. U.S. Dep't of Agric., 760 F.3d 18, 22–23 (D.C. Cir. 2014); *see* Supplemental Brief of the Securities and Exchange Commission at 1–3, Nat'l Ass'n of Mfrs. v. SEC, 748 F.3d 359 (D.C. Cir. 2014) (No. 13-5252), 2014 WL 6901084.

108. Business Roundtable v. SEC, 647 F.3d 1144, 1148–56 (D.C. Cir. 2011).

of legislative "sense" could justify virtually any securities reporting regulation aimed at virtually any humanitarian or social concern—regardless of cost.

Primary Violation of Rule 10b-5

Section 10(b) of the Exchange Act provides that it is "unlawful . . . to employ . . . any manipulative or deceptive device or contrivance in contravention of such rules . . . as [the SEC] may prescribe,"[109] with the principal rule being Rule 10b-5.[110] That rule has three subparts, which make it unlawful, "in connection with the purchase or sale of any security," respectively

> (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.[111]

While the SEC can bring enforcement actions against defendants who aid and abet violations of Rule 10b-5,[112] and while the Department of Justice can prosecute defendants who aid and abet or cause a violation of Rule 10b-5,[113] private plaintiffs can sue only primary Rule 10b-5 violators.[114] In recent years, the Supreme Court has decided two critical cases addressing the reach of the rule.

In *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, the Court held that suppliers to an issuer could not be sued in a private Rule 10b-5 action when the suppliers engaged in deceptive actions in transactions with the issuer and the issuer then recorded those transactions in a way that caused the issuer's publicly released financial statements to mislead the issuer's investors, who sued in the case.[115] The Court focused on reliance, which is an element in a private Rule 10b-5 case,[116] but not in an enforcement action brought by the government.[117] Because the suppliers' deceptive actions were not communicated to the public and the suppliers owed no duty to disclose to the issuer's investors, the Court held that purchasers of the issuer's stock did not rely *directly* on the suppliers' deception.[118] The Court then turned to "scheme liability," and

109. 15 U.S.C. § 78j(b) (2012).
110. 17 C.F.R. § 240.10b-5 (2014).
111. *Id.*
112. 15 U.S.C. § 78t(e) (2012). The SEC can now also pursue such individuals as control persons. *See* Dodd-Frank Act § 929P(c), 15 U.S.C. 78t(a) (2012).
113. Willful violation of the rule is a criminal offense. 15 U.S.C. § 78ff(a) (2012). The criminal code expressly punishes, as principals, those who aid and abet or cause federal criminal offenses. 18 U.S.C. § 2 (2012).
114. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008) ("The § 10(b) implied private right of action does not extend to aiders and abettors."); *id.* at 166 ("[T]he implied right of action in § 10(b) continues to cover secondary actors who commit primary violations . . . .").
115. *Id.* at 152–55.
116. *Id.* at 159.
117. *See* United States v. Vilar, 729 F.3d 62, 88 (2d Cir. 2013); SEC v. Goble, 682 F.3d 934, 942–43 (11th Cir. 2012).
118. *Stoneridge*, 552 U.S. at 159.

rejected the argument that investors who relied on misleading numbers in the issuer's financial statements had *indirectly* relied on the deceptive actions of the suppliers, which were all part of a scheme to produce the misleading numbers.[119] The majority agreed with the Eighth Circuit that had found that "any deceptive statement or act [by the suppliers] was not actionable because it did not have the requisite proximate relation to the investors' harm,"[120] and could only have been relied upon by those who purchased the issuer's stock through "an indirect chain . . . too remote for liability."[121] In particular, the suppliers' actions did not make it "necessary or inevitable for [the issuer] to record the transactions as it did."[122] While the Court did not expressly so state, its reference to "scheme liability" appeared to focus *Stoneridge* on subsections (*a*) and (*c*) of Rule 10b-5.[123]

In *Janus Capital Group, Inc. v. First Derivative Traders*—another private action—the Court interpreted subsection (*b*) of Rule 10b-5, by which it is unlawful "to *make*" a false or misleading statement, and which therefore, the Court held, creates primary liability only for "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[124] While the Court pointed out that this interpretation was consistent with the law that private Rule 10b-5 plaintiffs cannot sue aiders and abettors[125] and "the narrow scope that [courts] must give the implied right of action,"[126] the holding rested on the dictionary meaning of the word "make."[127] The Court then specifically held that "[o]ne who prepares or publishes a statement on behalf of another is not its maker," using the analogy of a speechwriter (who does not "make" the statements in a speech) and the speaker (who does "make" those statements, because "the content is entirely within the control of the person who delivers it").[128]

In 2014, two courts of appeals wrestled with *Janus* and its applicability to government enforcement actions. The Fourth Circuit held that *Janus* does not apply in criminal prosecutions.[129] The Eleventh Circuit found that *Janus* did not prevent the government from pursuing defendants as primary violators under Rule

119. *Id.* at 159–60.
120. *Id.* at 158–59.
121. *Id.* at 159.
122. *Id.* at 161.
123. When introducing its discussion of "scheme liability," the majority cited *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, 439 F. Supp. 2d 692, 723 (S.D. Tex. 2006). *Stoneridge*, 552 U.S. at 159–60. At the cited page, the *Enron* court held that "a plaintiff may bring a claim under Rule 10b-5(a) and (c) against a defendant allegedly 'directly or indirectly employing a manipulative or deceptive device . . . intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market.'" *In re Enron Corp.*, 439 F. Supp. 2d at 723 (citation omitted).
124. Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011).
125. *Id.*
126. *Id.* at 2303.
127. *Id.* at 2302.
128. *Id.*
129. *See infra* notes 131–41 and accompanying text.

10b-5(a) and (c)—even though the defendants' actions were quite similar to those of the defendants in *Stoneridge*.[130]

In *Prousalis v. Moore*, the Fourth Circuit affirmed a district court's dismissal of a habeas petition.[131] Prousalis was a securities lawyer who represented an issuer in an initial public offering ("IPO").[132] He had been convicted of a variety of offenses that rested factually on his preparation of IPO registration materials that failed to disclose that his fee for work on the IPO was contingent on the offering closing, and rested legally "in large part on his violation of SEC Rule 10b-5."[133] In order to obtain habeas relief, Prousalis had to show that, since his conviction, "the substantive law [had] changed such that the conduct of which [he] was convicted is deemed not to be criminal."[134] He argued that *Janus* had changed the law and that, under *Janus*, his preparation of the registration materials did not constitute "making" any of the false statements in them and, therefore, could not violate Rule 10b-5(b).[135]

In rejecting this argument, the Fourth Circuit interpreted *Janus* as "confined to cases invoking the implied private right of action and . . . not extend[ing] to the criminal convictions at issue here."[136] The court rested its reasoning on the circumstances that the *Janus* majority (i) stated that the Court granted certiorari to address Rule 10b-5(b) "in a private action";[137] (ii) framed its analysis around the previous law declining to extend aiding and abetting liability to private cases;[138] (iii) fit its reasoning with *Stoneridge* because, "unless a bad actor possesses ultimate authority, it is not 'necessary or inevitable' that the falsehoods he propagates will appear in any final statement filed with the SEC";[139] and (iv) expressly stated that its decision reflected the narrow construction appropriately accorded the implied *private* Rule 10b-5 right of action.[140] Having thereby rejected *Janus*' applicability, the Fourth Circuit—without *expressly* attempting to fit Prousalis'

130. *See infra* notes 142–46 and accompanying text.

131. 751 F.3d 272, 275, 279 (4th Cir. 2014), *cert. denied*, 135 S. Ct. 990 (2015).

132. *Id.* at 273–74.

133. *Id.* at 274. The issuer filed its offering on Form SB-2. BusyBox.com, Inc., Registration Statement (Form SB-2/A) (May 24, 2000). Item 13 of Form SB-2 required issuers to provide the information specified in Item 509 of Regulation S-B. Small Business Initiatives, 57 Fed. Reg. 36442, 36474 (Aug. 13, 1992) (to be codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 249 & 260). The registration statement identified Prousalis as the attorney opining on the validity of the securities being offered. BusyBox.com, Inc., Registration Statement (Form SB-2/A), at 44 & exh. 5 (May 24, 2000). Item 509 required a brief statement of his contingent fee. *See* 17 C.F.R. § 229.509 (2000). Prousalis admitted at his plea allocution to knowing that BusyBox.com, Inc. would not have been listed on NASDAQ if his fee had been described accurately. *Prousalis*, 751 F.3d at 274. Prousalis also "orchestrated a scheme in which IPO proceeds were recycled in order to purchase shares" after the offering failed to generate the originally anticipated amount. *Id.*

134. *Prousalis*, 751 F.3d at 275 (quoting *In re* Jones, 226 F.3d 328, 334 (4th Cir. 2000)).

135. *Id.* at 276. Prousalis was convicted in 2004. Prousalis v. United States, No. 03 CR 1509, 2007 WL 2438422, at *1 (S.D.N.Y. Aug. 24, 2007). The Supreme Court decided *Janus* in 2011. Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011).

136. *Prousalis*, 751 F.3d at 276.

137. *Id.*

138. *Id.* at 277.

139. *Id.* (quoting *Janus*, 131 S. Ct. at 2303).

140. *Id.*

conduct within any of the Rule 10b-5 subsections—painted in broad strokes, determining that Prousalis "orchestrated a sophisticated scheme to defraud" (*possibly* a reference to Rule 10b-5(a)), that it was "hard to imagine a scenario more germane to Congress's intentions in enacting the securities laws," and that his "conduct falls within the heartland of congressional concern."[141]

The Eleventh Circuit in *SEC v. Monterosso* took a very different route.[142] There, the court affirmed summary judgment entered against three defendants—including the manager of the issuer's wholesale telecom business (also the president of a subsidiary of the issuer) and a vice president of the subsidiary (also the owner of a second telecom company)—who worked together to create false invoices for approximately 58 percent of the issuer's reported 2004 revenue, 87.4 percent of the issuer's reported 2005 revenue, and 92 percent of the issuer's reported Q1 2006 revenue.[143] The Eleventh Circuit affirmed on the theory that the defendants were primary violators of Rule 10b-5, mentioning only in a footnote the alternative holding by the district court that the defendants were liable as aiders and abettors.[144] Because these defendants submitted the phony invoices to the issuer's accounting department but did not prepare the issuer's financial statements, they argued that they had not "made" the false financials under *Janus*, and therefore could not have violated Rule 10b-5.[145] The court of appeals held that *Janus* applies to subpart (b) of the rule, but not to subparts (a) and (c), and that "[t]he case against [the two defendants who created the false invoices] did not rely on their 'making' false statements, but instead concerned their commission of deceptive acts as part of a scheme to generate fictitious revenue for [the issuer]."[146]

Significance and analysis. These cases prompt five thoughts. First, it seems odd that government authorities keep pressing on primary liability when the law clearly permits them to pursue defendants on secondary liability theories.[147] Second, the government's persistence in this regard—even before *Janus*—produced opinions that expressly acknowledged that primary liability in private cases was different from primary liability in government enforcement actions.[148] Third, the *Prousalis* opinion fails to convince. While the *Janus* majority did

141. *Id.* at 279.

142. 756 F.3d 1326 (11th Cir. 2014).

143. *Id.* at 1329–31. The third defendant served as chief financial officer of the issuer; either he did not raise the *Janus* issue or the court concluded that it did not warrant discussion. *Id.* at 1329, 1333 & n.16.

144. *Id.* at 1336 n.20.

145. *Id.* at 1334.

146. *Id.* (observing that "*Janus* only discussed what it means to 'make' a statement for purposes of Rule 10b-5(b), and did not concern . . . Rule 10b-5(a) or (c)" and that "subsections (a) and (c) of Rule 10b-5 'are not so restricted' as subsection (b), because they are not limited to 'the making of an untrue statement of a material fact'" (quoting Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 152–53 (1972))).

147. *See supra* notes 112–13. For example, it has long been true that the SEC, through the aiding and abetting theory, can reach an attorney who knowingly participates in preparing a misleading SEC filing. *See* SEC v. Fehn, 97 F.3d 1276 (9th Cir. 1996).

148. *See* SEC v. Wolfson, 539 F.3d 1249, 1259–61 (10th Cir. 2008) (expressly declining to extend to SEC cases the primary liability tests developed in private actions because the private action tests derive from the reliance element that the SEC does not have to prove).

indeed repeatedly refer to the private nature of the case before the Court,[149] the majority decided the case on the basis of the dictionary meaning of the word "make"[150] and specifically stated that "we do not find the meaning of the word 'make' in Rule 10b-5 to be ambiguous."[151] The result-driven reasoning in *Prousalis* not only pushes *Janus* aside but then finds primary liability not in the words of *any* of the Rule 10b-5 subparts but in the court's view that the defendant's conduct fell "within the heartland of congressional concern"[152]—thereby disregarding the precise words on which courts have lavished attention for years. Fourth, *Monterosso* did not mention *Stoneridge*, even though *Stoneridge* had held that very similar deceptive acts to those in *Monterosso* did not constitute primary violations of Rule 10b-5 on which plaintiffs can sue in a private case.[153] Fifth, and accordingly, the *Monterosso* opinion (and possibly *Prousalis*, by its passing reference to "scheme") is somewhat more convincing if *Stoneridge* is properly read as a case arising under subsections (a) and (c) of Rule 10b-5, as *Stoneridge*'s reasoning is deeply intertwined with the reliance element that is unique to private cases. In that event, *Stoneridge* cabins primary liability under Rule 10b-5(a) and (c) only in *private* cases and not in public enforcement actions.

Insider Trading

The year 2014 saw courts of appeals publish three critical insider trading decisions. The Second Circuit held both that (i) Rule 10b-5 insider trading prohibitions apply in the sale of private company stock, and (ii) to the extent a fiduciary duty to abstain or disclose constitutes a prerequisite for such a prohibition, it is federal common law that defines that duty.[154] The Third Circuit ruled that the SEC had authority to adopt Rule 10b5-2, which nonexclusively defines the duty of trust and confidence that suffices as a predicate for applying the misappropriation theory of insider trading.[155] The Second Circuit held that, in order to be liable, a tippee must know that the tipper received a personal benefit from the tip.[156]

149. Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct., 2296, 2299 (2011) (presenting the question of whether "a mutual fund investment adviser[] can be held liable in a private action under Securities and Exchange Commission (SEC) Rule 10b-5 for false statements included in its client mutual funds' prospectuses"); *id.* at 2301 ("We granted certiorari to address whether JCM can be held liable in a private action under Rule 10b-5 for false statements included in Janus Investment Fund's prospectuses."); *id.* at 2302 ("[I]n analyzing whether JCM 'made' the statements for purposes of Rule 10b-5, we are mindful that we must give 'narrow dimensions . . . to a [private] right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'" (citation omitted)); *id.* at 2303 ("Our holding also accords with the narrow scope that we must give the implied private right of action.").

150. *See id.* at 2302.

151. *Id.* at 2303 n.8.

152. Prousalis v. Moore, 751 F.3d 272, 279 (4th Cir. 2014).

153. *See supra* notes 115–23 and accompanying text.

154. *See infra* notes 157–67 and accompanying text.

155. *See infra* notes 168–84 and accompanying text.

156. *See infra* notes 185–208 and accompanying text.

Trading in stocks of privately held companies/source of relevant fiduciary law for federal insider trading prohibition. Steginsky v. Xcelera Inc. addressed insider trading in the stock of a private company.[157] Although Xcelera Inc. ("Xcelera") had been a public company—at one time traded on the American Stock Exchange—the company did not disclose any financial information after 2005, and the SEC revoked its registration in 2006.[158] The Xcelera Board Chair/CEO, a director who was also the company's Executive Vice President ("EVP")/Secretary/Treasurer, and the company's majority shareholder formed a Maltese company called OFC Ltd. ("OFC"), and, in 2010, OFC made a tender offer for Xcelera stock at $0.25 per share.[159] The plaintiff sold her shares to OFC in the tender offer.[160] She sued, in part, on the theory that OFC was simply a vehicle through which the Xcelera insiders bought her shares based on material nonpublic information about Xcelera's financial condition.[161]

The plaintiff proceeded on the classical insider trading theory, which prohibits corporate insiders from trading in the stock of their company on the basis of undisclosed material information.[162] In vacating the district court dismissal of this claim,[163] the Second Circuit made three noteworthy holdings. First, the court held, as it had in previous decisions, that the plaintiff did not need to show "that corporate insiders *used* the nonpublic information; it [was] sufficient to prove that they traded their corporation's securities 'while knowingly in possession of the material nonpublic information.'"[164] Second, the appellate court held that—because section 10(b) of the Exchange Act applies to transactions in "any security registered on a national securities exchange *or any security not so registered*"—Rule 10b-5 insider trading law applies not only to trading the stocks of companies registered under the Exchange Act but also to trading the stocks of private companies.[165] Third, rejecting the argument that the duty of insiders to disclose or abstain should be governed by the corporate law of the jurisdiction in which the company is incorporated, the Second Circuit held that "the fiduciary-like duty against insider trading under section 10(b) is imposed and defined by federal common law, not the law of the Cayman Islands," where Xcelera was incorporated.[166]

157. 741 F.3d 365 (2d Cir. 2014).

158. *Id.* at 367–68.

159. *Id.* The Xcelera majority shareholder was a corporation owned by the Xcelera Board Chair/CEO and the father of the Xcelera director/EVP/Secretary/Treasurer. *Id.* at 367.

160. *Id.* at 368.

161. *Id.* at 369–70.

162. *Id.* at 370.

163. *Id.* at 371.

164. *Id.* at 370 (quoting from United States v. Rajaratnam, 719 F.3d 139, 159 (2d Cir. 2013)). This Second Circuit position accords with the SEC's position. 17 C.F.R. § 240.10b5-1 (2014). Not all circuits follow this rule. The Eleventh Circuit requires proof that the defendant *used* the inside information, but employs a "strong inference" that inside information is used if possessed, an inference that the defendant can rebut "by adducing evidence that there was no causal connection between the information and the trade—i.e., that the information was not used." SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998).

165. *Steginsky*, 741 F.3d at 371 (emphasis added by the court) (quoting 15 U.S.C. § 78j(b)).

166. *Id.*

Significance and analysis. Among other things, *Steginsky* means that a defendant cannot obtain an instruction that relies on state law to define the duty to disclose.[167]

Rule 10b5-2 as an authoritative, but non-exclusive, definition of the relationship relevant to misappropriation theory. In *United States v. McGee*, the Third Circuit affirmed the conviction of the defendant on the misappropriation theory of insider trading,[168] and, addressing an issue of first impression, held that the SEC rule interpreting that theory did not exceed the Commission's authority.[169] The misappropriation theory prohibits the recipient of material nonpublic information from trading on that information in violation of a duty owed to the source of the information.[170] In 2000, the SEC adopted Rule 10b5-2 to define, non-exclusively, the "duty of trust and confidence," the violation of which is sufficient to support an insider trading case under this theory.[171] Rule 10b5-2 provides that such a duty arises in three cases; in *McGee*, the court addressed Rule 10b5-2(b)(2), which provides:

> [A] "duty of trust or confidence" exists . . . [w]henever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality.[172]

McGee had purchased Philadelphia Consolidated Holding Corporation ("PHLY") shares after learning of the company's impending sale from an acquaintance McGee had befriended in Alcoholics Anonymous ("AA").[173] For some ten years before the stock purchase, McGee had "informally mentored [this acquaintance] in AA," and the two of them had "shared intimate details about their lives to alleviate stress and prevent relapses."[174] In view of "the sensitive nature of their communications, McGee assured [his acquaintance] that their conversations were going to remain private."[175] The government relied on Rule 10b5-2(b)(2) in its criminal case against McGee;[176] and on appeal, McGee contended that the SEC exceeded its authority by adopting a rule that permitted the government to

167. *See* United States v. Whitman, 555 F. App'x 98, 107 (2d Cir. 2014) (affirming conviction in insider trading case, relying on *Steginsky*, and stating: "Since Whitman does not argue that the district court misstated the relevant federal law, and challenges the instruction on duty only insofar as it failed to instruct on state law, we reject his claim of error in the district court's instruction."), *cert. denied*, 135 S. Ct. 352 (2014).

168. 763 F.3d 304, 308 (3d Cir. 2014), *cert. denied*, 135 S. Ct. 1402 (2015).

169. *Id.* at 312–16.

170. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

171. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51738 (Aug. 24, 2000) (to be codified at 17 C.F.R. § 240.10b5-2).

172. 17 C.F.R. § 240.10b5-2(b)(2) (2014).

173. *McGee*, 763 F.3d at 308.

174. *Id.* at 309.

175. *Id.*

176. *Id.* at 309–10.

pursue him without having to prove that he owed a *fiduciary* duty to the source of his information.[177]

The Third Circuit held that the SEC's rule was entitled to deference under *Chevron U.S.A., Inc. v. Natural Resource Defense Council, Inc.*, because (i) the statute that the rule extrapolated—Exchange Act section 10(b)—was silent on the duty necessary to support the misappropriation theory of insider trading, and (ii) Rule 10b5-2 followed from a permissible reading of that statute.[178] As to the first, the court observed that "§ 10(b) does not mention insider trading at all, much less misappropriation or relationships required for liability."[179] Nor was that gap definitively filled by Supreme Court decisions which, while those opinions recognized that insider trading required violation of a duty and endorsed use of the misappropriation theory in insider trading cases under Rule 10b-5, did "not unequivocally require a *fiduciary* duty for all § 10(b) nondisclosure liability."[180] As to the second *Chevron* prerequisite, the court held that "Rule 10b5-2(b)(2) is based on a permissible reading of 'deceptive device[s]' under § 10(b)."[181]

Having concluded that a Rule 10b5-2(b)(2) relationship provides a predicate for the misappropriation theory of insider trading, the Third Circuit had no difficulty finding sufficient evidence to support the jury verdict against McGee. Key in that evidence was the "understanding" between McGee and his acquaintance "that information discussed would not be disclosed or used by either party."[182]

Significance and analysis. *McKee* prompts two thoughts. First, Rule 10b5-2 has made courts and commentators uneasy, precisely because it imposes liability without requiring the violation of a fiduciary or fiduciary-like duty.[183] *McGee* may reflect declining judicial reluctance to employ the rule. Second, a Preliminary Note to the rule states that it is a "non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the 'misappropriation' theory.[184] Hence, violations of fiduciary relationships that do not fit within the rule should—even if courts broadly accept Rule 10b5-2—continue to support misappropriation insider trading claims.

Tippee knowledge of personal benefit to tipper. In *United States v. Newman*,[185] the Second Circuit continued the granular articulation of tippee liability that it began in *SEC v. Obus*.[186] The *Newman* appeal involved two defendants who received material nonpublic information about Dell and NVIDIA earnings and used

177. *Id.* at 312–13.
178. *Id.* at 312–16 (citing *Chevron*, 467 U.S. 837, 842–43, 845 (1984)).
179. *Id.* at 313.
180. *Id.* (emphasis added).
181. *Id.* at 316.
182. *Id.* at 317.
183. *See* Donald C. Langevoort, Insider Trading: Regulation, Enforcement & Prevention § 6:7, at 6-29 (2014) ("One obvious question is whether the SEC's rule goes too far in concluding that an agreement to keep information confidential establishes a fiduciary-like relationship.").
184. 17 C.F.R. § 240.10b5-2 (2014) (Preliminary Note).
185. 773 F.3d 438 (2d Cir. 2014).
186. 693 F.3d 276 (2d Cir. 2012).

that information in trading for portfolios they managed.[187] The defendants were remote tippees.[188] The tipping chain at Dell began with Rob Ray in Dell's investor relations department tipping Sandy Goyal, an analyst at Neuberger Berman, who passed the information on to others, who passed it on to yet others.[189] Newman was the third link in one branch of that tipping chain and Newman's co-defendant, Chiasson, was the fourth link in another branch of that chain.[190] The tipping chain at NVIDIA began with Chris Choi in NVIDIA's finance unit tipping Hyung Lim, who was a member of Choi's church, who passed the information on to others, who repeated it to others.[191] Both Newman and Ciasson were the fourth link in branches of that tipping chain.[192]

In *Dirks v. SEC*, the Supreme Court held that a tippee's liability under Rule 10b-5 requires that the tipper violate a duty in providing the information, that the tipper receive a personal benefit from tipping, and that the tippee know or should know that the tipper violated his or her duty.[193] In *Newman*, the Second Circuit reversed because the district court had not instructed the jury that the defendants needed to know that the original tippers received personal benefits for their tips and because the government had not presented sufficient evidence of such personal benefits.[194]

As to whether a tippee needs to know that the tipper received a personal benefit, the *Newman* panel relied on the straightforward analysis that, as set out in *Dirks*, the tippee's liability depends on the tipper's breach of duty and that breach of duty in turn requires that the tipper receive a personal benefit for the tip. Hence, the tippee's liability, depending on his or her knowledge of the tipper's breach, requires that the tippee know that the tipper received a benefit.[195] The trial court failed to instruct that the defendants had to know that the original tippers received some benefit for their tips.[196] That instructional error was not harmless because both defendants contended that they knew nothing about any such benefits, and the trial produced evidence sufficient to support a finding that the defendants did not have such knowledge.[197]

187. *Newman*, 773 F.3d at 443.
188. *Id.*
189. *Id.*
190. *Id.*
191. *Id.*
192. *Id.*
193. 463 U.S. 646, 661 (1983) ("In determining whether a tippee is under an obligation to disclose or abstain, it . . . is necessary to determine whether the insider's 'tip' constituted a breach of the insider's fiduciary duty."); *id.* at 663 ("[T]o determine . . . whether there has been a breach of duty by the insider . . . requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings."); *id.* at 660 ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.").
194. *Newman*, 773 F.3d at 442–43.
195. *Id.* at 442.
196. *Id.* at 444 (quoting instruction given).
197. *Id.* at 451.

The Second Circuit further held that the government failed to produce evidence showing that the original tippers did, in fact, receive personal benefits from their tipping.[198] Although prior circuit authority held that such a benefit need not be pecuniary and could extend to "the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend,"[199] the *Newman* panel held that "the personal benefit received in exchange for confidential information must be of some consequence."[200] "This standard, although permissive, does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature."[201] The standard would add nothing if it could be met by proof "that two individuals were alumni of the same school or attended the same church."[202] In *Newman*, the government had shown that the Dell tipper, Ray, received only some "career advice" from the first tippee, Goyal—advice of sort that Goyal routinely provided to acquaintances in the financial industry.[203] There was no evidence that the NVIDIA insider, Choi, received anything of value from the first tippee, Lim.[204]

Significance and analysis. The *Newman* court repeatedly wrote of the need to prove that the defendant "knew" that the insider received a personal benefit for the tip.[205] But *Dirks* held it sufficient that the tippee knew or should have known of the tipper's breach,[206] which, since *Dirks* is the basis for *Newman*'s holding that the tippee must know of the personal benefit, should mean it is sufficient for the government to prove that the tippee knew or should have known of the personal benefit. *Newman* recognizes this standard occasionally.[207] Given

198. *Id.* at 451–55.

199. *Id.* at 452 (quoting United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013)).

200. *Id.* The court elaborated so:

> To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades "resemble trading by the insider himself followed by a gift of the profits to the recipient," see 463 U.S. at 664, 103 S. Ct. 3255, we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.

Id.

201. *Id.*

202. *Id.*

203. *Id.* at 453.

204. *Id.*

205. *See, e.g.*, *id.* at 442 ("[T]he Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit."); *id.* at 450 ("[T]he Government must prove . . . that . . . the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit . . . .").

206. Dirks v. United States, 463 U.S. 646, 660 (1983) ("[A] tippee assumes a fiduciary duty . . . not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee *knows or should know* that there has been a breach" (emphasis added)).

207. *Newman*, 773 F.3d at 447, 455.

Dirks explicit statement on the matter, *Newman*'s seeming insistence on actual "knowledge" probably should be ignored.[208]

Remedies in Enforcement Actions

The year 2014 produced decisions demonstrating the extreme reach of sanctions that the government can impose for securities violations, as well as a fascinating case addressing the different roles that the SEC and the courts play when the SEC negotiates a settlement. The Second Circuit decided that a defendant could be required to disgorge the profits made by a fund that he managed when he used inside information to direct fund trades—even though that same court had decided that this same fund manager could not be required to pay those profits as restitution in his criminal case.[209] The Third Circuit affirmed millions of dollars in disgorgement in a case where the defendant had violated Exchange Act section 13(d) on the basis that he would not have made the profits "but for" the 13(d) wrongdoing.[210] The Second Circuit held that a district court abused its discretion by refusing to approve a proposed settlement in an SEC enforcement action, with the trial court basing the refusal on its view that the settlement should have included an agreed statement of facts.[211]

Disgorgement of money that the defendant does not personally receive. Two Second Circuit cases—the last one decided in 2014—vividly demonstrate the dangers of parallel criminal and civil enforcement proceedings. In 2012, the Second Circuit affirmed the insider trading conviction of Joseph Contorinis, a fund manager who caused his fund to trade on material nonpublic information that Contorinis had received, but reversed the more than $12,000,000 restitution award in that criminal action on the grounds that the profits the fund made and the losses that it avoided "were never possessed or controlled by [Contorinis] or others acting in concert with him.[212] The appellate court remanded so that the trial court could determine "[t]o what extent [the defendant's] interest in salaries, bonuses, dividends, or enhanced value of equity in the Fund can be said to be money 'acquired' by the defendant 'through the illegal transactions resulting in the forfeiture.'"[213] On remand, "the district court found that Contorinis's personal profit, in the form of linked compensation from the trades, amounted to $427,875, and ordered forfeiture of that amount."[214]

The SEC pursued Contorinis in a parallel civil enforcement proceeding, successfully moving for summary judgment against him in that case based on his

208. Of course, as *Newman* points out, if the government brings a criminal prosecution under section 32(a) of the Exchange Act for violation of Rule 10b-5 by insider trading, the government must prove that the defendant acted "willfully." *Id.* at 447 (quoting 15 U.S.C. § 78ff(a)).

209. *See infra* notes 212–29 and accompanying text.

210. *See infra* notes 230–63 and accompanying text.

211. *See infra* notes 264–78 and accompanying text.

212. United States v. Contorinis, 692 F.3d 136, 148 (2d Cir. 2012). The district court also sentenced Contorinis to seventy-two months in prison. *Id.* at 141. The Second Circuit affirmed Contorinis' conviction but reversed the forfeiture order. *Id.* at 148.

213. *Id.* at 148 n.4 (quoting 18 U.S.C. § 981(a)(2)(B)).

214. SEC v. Contorinis, 743 F.3d 296, 300 (2d Cir. 2014) [hereinafter *Contorinis II*].

criminal conviction.[215] In addition to entering an injunction against further securities violations, the district court in the SEC action ordered Contorinis to disgorge an amount equal to the profits (less commissions) that his fund made on the inside information, which totaled $7,260,604 (less any amount paid pursuant to the criminal forfeiture), as well as to pay prejudgment interest on that amount, which totaled $2,417,940,[216] and a civil penalty of $1,000,000.[217] Thus, through the parallel civil case, the government took from Contorinis personally, through disgorgement, the profits made by the fund he managed, even though the government had been unable to take that money from him, personally, through a forfeiture order in the criminal action.

Contorinis appealed the forfeiture order, arguing that disgorgement is designed to take from the wrongdoer the ill-gotten gains that he or she received but not money that he "never personally controlled."[218] In a two-to-one decision, the Second Circuit affirmed.[219] The majority reasoned that, because a tipper can be forced to disgorge the profits of his or her tippee, "it must follow that the insider who, rather than passing the tip along to another, directly trades for that other's account must equally disgorge the benefit he obtains for his favored beneficiary."[220]

Significance and analysis. Aside from showing that, through parallel proceedings, the government can extract enormous amounts of money from a defendant, the 2014 *Contorinis* decision is important for three reasons. First, the majority acknowledged that the SEC could have pursued the fund that Contorinis managed to recover from the fund, as a relief defendant, the profits the fund made from trades on the inside information. The majority observed that the SEC simply "chose, as [circuit] case law has indicated is an established and legitimate alternative, to seek damages from the wrongdoer Contorinis directly."[221] The majority seemingly endorsed this Commission decision by writing that "one argument in favor of requiring disgorgement from the trader is that he is culpable, while the third-party recipients, though unjustly enriched, may have been unaware of any wrongdoing."[222] Thus, the windfall to the fund stood.

Second, the *Contorinis* majority suggested that "benefit" for insider trading purposes—and benefit is required for tipper liability[223]—can include "psychic satisfaction."[224] Even a reasonably imaginative SEC enforcement attorney or

215. *Id.*
216. *Id.* at 300, 301 n.1.
217. *Id.* at 300.
218. *Id.* at 301.
219. *Id.* at 309.
220. *Id.* at 303. The panel added that, if anything, the case for disgorgement in *Contorinis* was stronger than where the defendant was merely a tipper. *Id.* While a tipper "has no control over, and likely no knowledge of, the extent to which the tippee will trade," Contorinis "controlled the size and timing of the trades, and was then entirely responsible for the size of the . . . Fund's gains." *Id.* at 303–04.
221. *Id.*
222. *Id.*
223. *See supra* note 193 and accompanying text.
224. *Contorinis II*, 743 F.3d at 303 ("Whether the defendant's motive is direct economic profit, self-aggrandizement, psychic satisfaction from benefitting a loved one, or future profits by enhancing

prosecutor should be able to conjure at least *some* psychic satisfaction from virtually any tipping. Read broadly, this reasoning eliminates the "personal benefit" element of tipping as a practical matter and as an effective limitation of liability. Subsequently, in *Newman*, the Second Circuit implicitly limited the reach of this aspect of *Contorinis*, holding there that the personal benefit "must be of some consequence."[225]

Third, *Contorinis* approves an odd bit of judicial hypocrisy. When imposing the criminal sentence, the district court said; "I don't think there is any chance that you are going to commit crimes in the future" and that Contorinis's insider trading scheme was "relatively isolated."[226] In the SEC enforcement action, however, the district court permanently enjoined Contorinis from future securities violations,[227] which required a finding of a "'reasonable likelihood' that the defendant will violate the securities laws in the future."[228] On appeal of the injunction, the Second Circuit majority brushed the inconsistency aside with the explanation that the remarks in the criminal case "must be read in the context of a criminal sentencing proceeding in which the court was considering possible grounds for leniency in sentencing, not the need to impose a civil injunction."[229]

Remedy for section 13(d) violation. Exchange Act section 13(d) requires any person who acquires beneficial ownership of more than five percent of any equity security registered under section 12 of that act to make filings as required by the SEC within ten days after crossing that ownership threshold.[230] SEC Rule 13d-1 requires that the more-than-five-percent-shareholder make such filings on Schedule 13D, unless the investor falls into one of a number of specified categories (such as a registered broker/dealer or investment company) and the investor "acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer"—in which case the investor may file on Schedule 13G.[231] All shares over which the investor has voting control and investment power (including the power to sell or direct sale) contribute to the total number of shares beneficially owned by that investor, regardless of how those shares are held.[232]

A Schedule 13D must include a statement of the acquiring shareholder's "purpose or purposes of the acquisition" and "any plans or proposals" that the shareholder "may have which relate to or would result in," among other things, the acquisition of additional shares, an extraordinary corporate transaction, or any

one's reputation as a successful fund manager, the insider trader who trades for another's account has engaged in a fraud, secured a benefit thereby, and directed the profits of the fraud where he has chosen them to go.").

225. United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014).

226. *Contorinis II*, 743 F.3d at 308 n.7.

227. *Id.* at 308.

228. SEC v. Goble, 682 F.3d 934, 948 (11th Cir. 2012) (citation omitted).

229. *Contorinis II*, 743 F.3d at 308 n.7.

230. 15 U.S.C. § 78m(d) (2012).

231. 17 C.F.R. § 240.13d-1 (2014) (also defining other categories of shareholders who may file on Schedule 13G).

232. *Id.* § 240.13d-3(a)–(c).

change in the board of directors.[233] The investor must file an amended Schedule 13D if "any material change occurs in the facts set forth" in the most recently filed schedule, with the acquisition or disposition of one percent or more of the equity securities "deemed" to be material for purposes of requiring an amendment.[234]

While the issuer can pursue an implied right of action for a violation of section 13(d),[235] the relief in such a *private lawsuit* is essentially limited to a prophylactic filing.[236] Indeed, the Second and Fifth Circuits have held that the issuer's remedies do not include damages.[237] *SEC v. Teo*, however, vividly reminded investors last year that the SEC can extract money, and lots of it, from a section 13(d) violator in a *public enforcement action*.[238]

Alfred Teo, who had established the MAAA Trust (the "Trust"), filed a Schedule 13D disclosing beneficial ownership of more than five percent of stock issued by Musicland Stores Corporation ("Musicland") held in various brokerage accounts that Teo controlled, including brokerage accounts for the Trust.[239] On July 30, 1998, he filed an amendment stating that he had "ceased to have investment powers with respect to the Trust"—even though, in fact, he continued to make investment decisions for that entity.[240] Teo's own filings and those of the Trust thereafter intentionally concealed the fact that he beneficially owned more than the 17.5 trigger percentage for the Musicland poison pill, with Teo's ownership and that of the Trust having crossed the pill's threshold by early August 1998, risen to nearly 36 percent by December 2000, and remained above the pill's trigger at least until the end of January 2001.[241]

As he concealed this large ownership, Teo asked multiple times to be added to the Musicland board, lobbied for the addition of others to that board, and consulted with multiple financial advisors about plans to take Musicland private.[242] He did not disclose any of these activities in any amendments to his Schedule 13D.[243] In December 2000, Best Buy Co. ("Best Buy") made a cash tender

233. *Id.* § 240.13d-101 (Item 4).

234. *Id.* § 240.13d-2(a).

235. *See, e.g.*, CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 654 F.3d 276, 284 (2d Cir. 2011).

236. *Id.* at 286 ("[T]he interests that section 13(d) protects are fully satisfied when the shareholders receive the information required to be filed." (internal quotation marks omitted)).

237. Motient Corp. v. Dondero, 529 F.3d 532, 535–36 (5th Cir. 2008); Hallwood Realty Partners, L.P. v. Gotham Partners, L.P., 286 F.3d 613, 620–21 (2d Cir. 2002).

238. 746 F.3d 90 (3d Cir. 2014), *cert. denied*, 135 S. Ct. 675 (2014).

239. *Id.* at 93. The Third Circuit identified the issuer informally, but the district court provided its formal name. SEC v. Teo, No. 2:04-cv-01815 (SDW) (MCA), 2011 WL 4074085, at *1 (D.N.J. Sept. 12, 2011).

240. *Teo*, 746 F.3d at 93–94 (quoting the Schedule 13D). The district court found, on summary judgment, "that Teo was the beneficial owner of shares of Musicland Stores Corporation ('Musicland') held by the MAAA Trust," noting that "Teren Seto Handelman, a former trustee of the Trust, testified that during her time as trustee, Teo would make decisions regarding trades and tell her to approve them." *Teo*, 2011 WL 4074085, at *1 & n.2.

241. *Teo*, 746 F.3d at 93–94.

242. *Id.* at 94.

243. *Id.*

offer for all Musicland shares, and Teo sold some of the shares he beneficially owned into the market at a price boosted by that tender offer, then sold the rest into the tender offer in January 2001.[244]

In a criminal proceeding, Teo pled guilty to insider trading for buying Musicland stock while possessing material nonpublic information about the impending Best Buy deal.[245] In the SEC's civil enforcement proceeding, a jury found that Teo had violated section 13(d) and Rule 10b-5,[246] due to misrepresentations in, and omissions from, the Schedule 13D filings.[247] The jury found that, in addition to Teo himself, the Trust had violated section 13(d).[248]

In affirming,[249] the Third Circuit rejected the argument that Teo's undisclosed actions directed towards taking Musicland private were only "embryonic" and therefore did not amount to "plans and proposals" for an extraordinary transaction that had to be reported in an amended Schedule 13D.[250] The court held that Teo's "serial efforts with three investment banks to find backing for a leveraged buyout of outstanding Musicland stock," which included signing a term sheet with one bank and a meeting with that bank and Musicland "to discuss the plan," "was substantial evidence for a jury to conclude that Teo had a plan or proposal for an extraordinary corporate transaction."[251] Similarly, his "numerous conversations with Musicland representatives both about his intention to become a Board member and about his intent to have three of his associates placed on the Board"—which included his monthly requests during 2000 to be added to the board and his written communications with Musicland in which he forwarded the resumes of his associates and asked that they become directors—sufficiently supported the jury's conclusion that Teo had violated section 13(d) by failing to report a plan or proposal to change the company's board.[252]

More controversial, and more interesting here, the Third Circuit affirmed a \$17,422,054.13 disgorgement award, computed as the profits on the sale of shares held after July 30, 1998,[253] plus \$14,649,034.89 in prejudgment interest.[254] While Teo argued that the profits resulted solely from the Best Buy tender offer and had nothing to do with the section 13(d) violation, and therefore the SEC had failed to demonstrate that the profits proceeded "proximately" from the

244. *Id.*

245. *Id.* at 94 nn.2–3, 95.

246. *Id.* at 94. The SEC also pursued Teo and the Trust for violations of section 16(a) and certain SEC rules. *Id.* at 94–95.

247. *Teo*, 746 F.3d at 107 ("The SEC introduced evidence of the Appellants violating Section 13(d) and Section 10(b), beginning on July 30, 1998, by intentionally misrepresenting Teo's beneficial ownership of shares held by the MAAA Trust, thereby underreporting the percentage of Musicland shares that he beneficially owned.").

248. *Id.* at 94.

249. *Id.* at 110.

250. *Id.* at 99; *see also supra* note 233 and accompanying text.

251. *Teo*, 746 F.3d at 100.

252. *Id.*

253. *Id.* at 94, 95 n.4 (describing calculation).

254. *Id.* at 109.

violation,[255] the court of appeals held that the proximate cause analysis derived from tort law concepts applied in implied private actions under the securities laws, but not government enforcement actions.[256] The Third Circuit conceded that "the difference between private enforcement suits and SEC suits does not entirely eliminate the need for proof of a causal connection between the securities violation and the disgorged funds."[257] But applying the rule that the SEC need only prove a "reasonable approximation" of profits from violations, with the burden then shifting to the defendant to show that the SEC's approximation is not reasonable,[258] the court held that the Commission needs to do no more "than prove but-for causation to assert a reasonable approximation of illegal profits."[259] While the Third Circuit acknowledged that, after the SEC provides a reasonable approximation, a defendant can defeat the required causation by proving an intervening cause,[260] the court found no "specific evidence" of such a cause here, commenting that "[m]erely positing the Best Buy tender offer as an intervening cause and pointing to evidence that Appellants did not bring [the tender offer] about was insufficient to overcome the presumption established by the SEC that its approximation of illegal profits was reasonable."[261]

Significance and analysis. It is difficult to follow how the violations of section 13(d) constituted a "but for" cause of the profits. The dissent suggested that the violations "may well" have meant that Teo bought shares more inexpensively than he would have had he disclosed his holdings and plans in conformity with section 13(d).[262] By that reasoning, however, Teo should have disgorged only the profits on the *shares bought after the violations*, and not on the *shares held at the time the violations began*.

The majority said that "Teo's flagrant fraud insulated the valuation of the Appellants' Musicland stock holdings from the effects of a poison pill that could have been activated if the extent of their holdings in the company had been known,"[263] but, having raised the point, the majority failed to complete the analysis. Who knows what would have happened if the pill had been triggered? Perhaps the share price would have dropped, or perhaps the price would have increased on the notion that the large holding portended changes that could better the company's financial performance. In any event, following the majority's

255. *Id.* at 101.
256. *Id.* at 102–03.
257. *Id.* at 103.
258. *Id.* at 105 (quoting SEC v. First City Fin. Corp., 890 F.2d 1215, 1231–32 (D.C. Cir. 1989)).
259. *Id.* at 107.
260. *Id.* at 106 ("[I]f the issue of an intervening cause is to be raised, it will normally be the defendant's burden to do so.").
261. *Id.* at 108.
262. *Id.* at 111 (Jordan, J., dissenting). The dissent concluded that the district court abused its discretion by requiring the disgorgement of profits resulting from Best Buy's tender offer. *Id.* at 112 (Jordan, J., dissenting) ("Appellants . . . point to the Best Buy tender offer as an independent cause."); *id.* at 113 (Jordan, J., dissenting) ("The Best Buy tender offer is clearly an independent and intervening event . . . [as Teo had] nothing to do with finding Best Buy and Best Buy was fully aware of . . . [Teo's holdings]." (internal quotation marks omitted)).
263. *Id.* at 109.

logic, disgorgement should have been limited to profits on *shares held after the holdings crossed the pill threshold*.

With the calculation hard to relate to the court's logic, the case leaves the impression that, in a section 13(d) case, the SEC can recover as disgorgement all profits on all shares held at any time that the investor was out of compliance with the statute.

Court role in remedy when approving SEC-proposed settlement. The SEC sued Citigroup Global Markets, Inc. ("Citigroup"), alleging that Citigroup sold interests in a fund through representations that an independent investment advisor selected the fund's assets, when, according to the complaint, Citigroup itself selected many of the assets and Citigroup had taken short positions in those assets.[264] The SEC proposed a settlement of $285 million (including disgorged profits ($160 million), interest on those profits ($30 million), and a civil penalty ($95 million)), an injunction against future violations of section 17(a)(2) and (3) of the Securities Act, and internal changes at the company.[265] The district court judge declined to approve the settlement after asking the parties a series of questions indicating that he was skeptical of (i) the failure to include in the settlement an admission of wrongdoing, (ii) the amount of the penalty, (iii) the SEC's claim that it could not identify individually culpable Citigroup employees, and (iv) the SEC's allegation that the violation resulted from simple negligence.[266] The trial court found that the settlement was "neither fair, nor reasonable, nor adequate, nor in the public interest" because, without some agreed statement of facts, the parties had not "provide[d] the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards."[267]

The Second Circuit vacated the lower court's order because the district judge had abused his discretion.[268] The appellate court held "that the proper standard for reviewing a proposed consent judgment involving an enforcement agency requires that the district court determine whether the proposed consent decree is fair and reasonable," and, where the relief includes an injunction, "that the 'public interest would not be disserved.'"[269] This involves, in the context of an SEC settlement, assessing the legality of the requested order; determining whether the terms of the order are clear, "including its enforcement mechanism"; concluding that the order resolves the claims in the complaint; and assessing whether the settlement "is tainted by improper collusion or corruption of some kind."[270] The court, however, must "tak[e] care not to infringe on the S.E.C.'s discretionary authority to settle on a particular set of terms,"[271] which means that the court

264. SEC v. Citigroup Global Mkts., Inc., 752 F.3d 285, 289 (2d Cir. 2014).
265. *Id.*
266. *Id.* at 289–90.
267. *Id.* at 290 (quoting SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 332 (S.D.N.Y. 2011)).
268. *Id.* at 289, 298.
269. *Id.* at 294 (quoting eBay, Inc. v. MercExchange, LLC, 547 U.S. 388, 391 (2006)).
270. *Id.* at 294–95.
271. *Id.* at 295.

does not rule on (i) whether the settlement is "adequate,"[272] (ii) whether it is advisable to settle without an admission of wrongdoing or without providing collateral estoppel rights for private lawsuits,[273] or (iii) whether the agency pled the claims that the district judge thought best.[274] While the district court must, where the settlement includes an injunction, determine that the decree will not disserve the public interest, the court cannot find disservice on the basis that the public is entitled to the "truth" about the underlying events and that the settlement does not provide the truth.[275] Although the district court needs some evidentiary basis for its work, "[i]n many cases, setting out the colorable claims, supported by factual averments by the S.E.C., neither admitted nor denied by the wrongdoer, will suffice to allow the district court to conduct its review."[276]

Significance and analysis. Counsel for the district court stated that the judge below had not required an admission of guilt as a prerequisite for approving the settlement.[277] Nevertheless, the trial court's decision in 2011 denying approval for the settlement brought into public debate the Commission's practice of settling without any such admissions. In 2012 and 2013, the SEC announced a modification of that practice.[278]

Disclosure of Drug Testing Results and Prospects for FDA Approval

Securities law disclosures in the drug and medical device industry present special challenges.[279] Last year produced three significant opinions in this specialized area. The Sixth Circuit found no strong inference of scienter where a company reported positive results of its device on a modified intent-to-treat population even though the FDA later criticized use of that population for analysis and denied approval for the device.[280] The Third Circuit held that plaintiffs failed to plead the falsity of a company's statement that an interim look at Phase II results contributed to a decision to proceed to Phase III testing—even though plaintiffs alleged the company later announced that a completed review of the Phase II testing showed no efficacy.[281] The First Circuit held that a complaint failed to adequately allege scienter where a company kept shareholders apprised of the FDA approval schedule for

272. *Id.* at 294.
273. *Id.* at 297.
274. *Id.*
275. *Id.* As the court pithily put it: "Trials are primarily about the truth. Consent decrees are primarily about pragmatism." *Id.* at 295.
276. *Id.* at 295.
277. *Id.* at 293.
278. *See* Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Remarks to the Council of Institutional Investors (Sept. 26, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539841202#.VJXgZoCABg.
279. *See* William O. Fisher, *Key Disclosure Issues for Life Sciences Companies: FDA Product Approval, Clinical Test Results, and Government Inspections*, 8 Mich. Telecomm. & Tech. L. Rev. 115 (2002).
280. *See infra* notes 283–97 and accompanying text.
281. *See infra* notes 298–321 and accompanying text.

a biologic but (i) did not disclose negative observations in a Form 483 until the FDA communicated that those observations, and the company's response to them, endangered the pending biologic license application, and (ii) did not disclose bioreactor failures at two production facilities until the company learned—through its own investigation—what had caused the failures.[282]

Treatment population analyzed for efficacy. The defendant company in *Kuyat v. Biomimetic Therapeutics, Inc.* developed a device to stimulate bone growth in patients who undergo foot and ankle surgeries.[283] In the process of seeking permission from the FDA to conduct clinical trials, the company stated that it would evaluate the effectiveness of the device by examining an "intent-to-treat" ("ITT") population "defined as all randomized subjects who received treatment post randomization [and specifically excluding p]atients who are randomized and unable to be treated [and who accordingly would be excluded as] surgical screening failures."[284] The FDA responded with a May 18, 2007 letter stating that (i) the ITT population "should be defined as all randomized subjects in the treatment groups to which they were assigned, regardless of whether they actually received the assigned treatment or not," (ii) the company "should plan to analyze the true ITT population," and (iii) the company "may analyze additionally a group of patients excluded from the ITT due to 'surgical screening failure' . . . ; however, this should be considered and referred to as a 'modified ITT' [mITT] population."[285]

After the clinical trials concluded, a company press release dated October 13, 2009 disclosed that analysis of the mITT population showed the device produced statistically significant positive results but that analysis of the ITT population did not show statistically significant benefit.[286] The company's share price dropped 16 percent.[287] The FDA reacted to the company's application for premarket approval with a September 3, 2010 deficiency letter questioning reliance on the mITT population to demonstrate effectiveness.[288] After the company answered that the FDA's May 18, 2007 letter had approved analysis of the mITT population and that the exclusion of the additional patients from the ITT had not biased results,[289] the FDA issued an advisory briefing on May 9, 2011 criticizing use of the mITT for analysis because that population did not preserve the benefit of randomization.[290] The company's stock price dropped again, this time by 35 percent.[291] Although an FDA advisory panel narrowly recommended

282. *See infra* notes 322–50 and accompanying text.

283. 747 F.3d 435, 437 (6th Cir. 2014).

284. *Id.* at 438 (quoting the company's April 16, 2007 supplement to its request for clinical trial permission).

285. *Id.* (quoting FDA letter).

286. *Id.*

287. *Id.* at 439.

288. *Id.*

289. *Id.* at 439–40. The company argued that, because it defined the excluded patients before the trials began, the definition was not an after-the-fact effort to cherry pick a population that showed success. *See id.* The company also contended that the mITT population was clinically more relevant. *See id.*

290. *Id.* at 440.

291. *Id.*

approval of the device (with the narrow margin occasioning a further 10 percent stock price decline) the FDA issued a non-approval letter on January 3, 2012.[292]

Investors brought a Rule 10b-5 action contending that the company's positive statements about the clinical trial results were false because the company knew that the FDA would base approval on analysis of the ITT, rather than the mITT, population and that company statements specifically referencing efficacy in the mITT population were misleading because the company knew that was not the population that the FDA had approved.[293] Affirming judgment for the defense on a motion to dismiss,[294] the Sixth Circuit's "holistic" analysis found that "an inference of scienter [was] not as strong as the opposing inference" that the company "legitimately believe[d] that the statistically significant results it achieved based on an analysis of the mITT population would be sufficient to obtain approval by the FDA."[295] The key document was the FDA's May 18, 2007 letter. While the Sixth Circuit recognized that the letter made clear "that the FDA expected [the company] to conduct an analysis of both a 'true ITT' and an mITT population," the "letter [did] not indicate that the FDA wanted the primary effectiveness analysis to be conducted on the ITT population" but rather focused on ensuring that the company correctly defined the ITT population.[296] Although the May 9, 2011 briefing "clearly . . . state[d] that the primary analysis should be based on the ITT population," the FDA released that document "well after the allegedly misleading statements were made."[297]

Effectiveness in treatment of clinical subpopulation/decision to proceed to Phase III without final results from Phase II. Drug testing often suggests that a new pharmaceutical product, though not effective for an entire set of patients, may be effective for some subset. *City of Edinburgh Council v. Pfizer, Inc*. dealt with statements regarding the shift of focus to such a subset.[298] Wyeth, Inc. (later bought by Pfizer, which became

292. *Id*.

293. *Id*. at 441. The company had "characterized the study as producing 'positive top line results,' said that the company was 'encouraged by the results seen to date in [the device's] clinical development,' and stated that it felt 'confident in the [pre-market approval that the company] submitted for [the device] . . . .'" *Id*. The company stated, in a 2009 earnings call, that it met its "prespecified primary endpoint and believe[d] that [it had] demonstrated a clear picture of non-inferiority" and, in a 2010 press release, "referred to the mITT population as 'the prespecified primary study population.'" *Id*. (quoting public comments).

Although the appellate opinion refers only generally to securities fraud, *id*. at 436, it emphasizes scienter, *id*. at 441, and the complaint pled a violation of Rule 10b-5. Consolidated Amended Class Action Complaint at ¶¶ 168–77, Sarafin v. Biomimetics Therapeutics, Inc., No. 3:11-0653, 2013 WL 139521 (M.D. Tenn. Jan. 10, 2013), 2011 WL 7735097.

294. *See Kuyat*, 747 F.3d at 445.

295. *Id*. at 441.

296. *Id*. at 442 (adding that "[t]he letter sa[id] nothing either way about whether ITT must or must not serve as the primary benchmark for success").

297. *Id*.; *see id*. at 443 (summarizing that "[the company] may have ultimately been wrong about which population would be analyzed for the primary effectiveness analysis, but a reasonable person would more easily than not infer that [the company] believed that it had permission to use an mITT population for the analysis at the time that it spoke to investors").

298. 754 F.3d 159 (3d Cir. 2014).

the defendant as a result of that purchase) conducted a Phase II trial[299] of a drug to treat Alzheimer's disease.[300] At an analyst meeting on October 5, 2006, the Wyeth head of research said that Wyeth would review the Phase II results, on an interim basis, at the end of 2006 and, "depending on the data, [it] could advance directly into Phase III in the first half of 2007, but the results would have to be spectacular."[301]

On May 21, 2007, a Wyeth press release announced the company's decision to commence Phase III trials—even though the Phase II results were not yet available—and that the decision to proceed to the next phase "was based on the seriousness of the disease and the totality of what [had been] learned from . . . immunotherapy programs, including a scheduled Interim look at data from an ongoing Phase [II] study, which remains blinded."[302] The press release added that readers should draw "[n]o conclusion about the Phase [II] study . . . until the study is completed and the final data are released and analyzed in 2008" and also reminded readers that proceeding to Phase III was "subject to regulatory approval."[303]

On June 17, 2008, Wyeth disclosed in a press release that "preliminary findings" from the Phase II test failed to show the drug's efficacy in treating the test population as a whole, but noted that the drug showed "'statistically significant and clinically meaningful benefits' among non-carriers of the ApoE4 gene who are believed to make up 40 to 70 percent of Alzheimer's patients" and that this circumstance supported the decision to move to Phase III tests.[304] A July 29, 2008 press release—that the plaintiffs contended finally revealed "that the Phase [II] trial was nearly a complete failure—[disclosed that] the results showed no efficacy and revealed serious safety concerns."[305]

Suing for violation of Rule 10b-5 on behalf of all who bought Wyeth stock between May 21, 2007 and July 29, 2008,[306] plaintiffs made two important arguments. First, they contended that the May 21, 2007 press release was false because the decision to proceed with Phase III testing could not have been "based on" an interim look at the Phase II data.[307] To support this allegation of falsity,

299. *Id.* at 163 n.5 ("FDA regulations require three phases of clinical trials—which may overlap—to assess the efficacy and safety of potential new treatments. 21 C.F.R. § 312.21. Phase [I] tests the drug's efficacy and safety on a small number of patients. Phase [II] is a controlled clinical study in which various doses of the drug are tested on groups of up to several hundred patients to evaluate preliminary indicia of the drug's efficacy and safety. Phase [III] studies—randomized, multicenter trials on large patient groups over an extended period—aim to provide sufficient evidence of efficacy and safety to support FDA approval to market the drug.").

300. *See id.* at 162. Wyeth and Elan Corporation, p.l.c. ("Elan") had formed a joint venture to develop the drug. *Id.* at 163. The plaintiffs had purchased Wyeth stock. *Id.* at 162. While Wyeth and Elan jointly undertook many of the actions described above, this Survey attributes those actions to Wyeth for ease of exposition and because the plaintiffs purchased the stock of, and sued, only Wyeth.

301. *Id.* at 163–64 (quoting Wyeth's head of research).

302. *Id.* at 164 (quoting the press release).

303. *Id.* (quoting the press release).

304. *Id.* at 165 (quoting the press release). The same press release also "reported serious adverse events" among the treated patients. *Id.*

305. *Id.*

306. *Id.* at 162–63.

307. *Id.* at 168.

the plaintiffs relied on confidential witnesses who stated that (i) the interim results did not show statistically significant efficacy measured by pre-specified p-values, (ii) the interim tests raised significant safety concerns, and (iii) five professionals within Wyeth disagreed with the decision to proceed to Phase III trials.[308] The implication was that, because the interim review showed that the Phase II trials were failing, the decision to proceed to Phase III could not have been "based on" that review. The Third Circuit nevertheless affirmed the district court decision dismissing the case.[309] The appellate court held that, "[b]ecause defendants never told investors [the drug] would only pass the interim review if specific p-values, dose responses, or safety metrics were achieved," the reports of the confidential witnesses did not establish with sufficient specificity the falsity of the statement that "the decision to initiate Phase [III] was based in part on the Phase [II] interim review."[310]

Moreover, the appellate court noted that the confidential witnesses themselves acknowledged that the interim results showed at least "circumstantial evidence of efficacy" in the subgroup of patients without the ApoE4 gene and that some of the five who disagreed with the decision to proceed with a Phase III study simply wanted another Phase II study that focused on a population limited to those without the ApoE4 gene.[311] All of this, as the Third Circuit concluded, constituted only "a difference of opinion," thereby implicating the rule that "[o]pinions are only actionable under the securities laws if they are not honestly believed and lack a reasonable basis."[312] Not only did the plaintiffs fail to allege the absence of honest belief or lack of a reasonable basis, but "the initiation of Phase [III] cost millions of dollars and required FDA approval . . . rendering it improbable that the defendants would have continued if they did not believe their interpretation of the interim results or if they thought the drug a complete failure."[313] Further, "the disagreement of five employees within a large pharmaceutical company about the interpretation of clinical trial data and the critical strategic decision of initiating an expensive Phase [III] trial [did] not render defendants' decisions unreasonable."[314]

The plaintiffs' second argument rested on the relationship between the October 5, 2006 statement—that the interim results from Phase II "would have to be spectacular" for the company to "advance directly into Phase III in the first half of 2007"[315]—and the company's later disclosures. The court rejected the argument that the May 2007 release, by stating that the company was moving to Phase III, implied, in light of the October 2006 statement, that the interim Phase II results

308. *Id.* at 169–71.
309. *Id.* at 177.
310. *Id.* at 170.
311. *Id.* at 170–71 (quoting confidential witnesses).
312. *Id.* at 170 (observing that "[i]nterpretations of clinical trial data are considered opinions").
313. *Id.*
314. *Id.* at 171.
315. *Id.* at 165.

were indeed "spectacular."[316] The Third Circuit noted that the May 2007 release "did not characterize or discuss the strength of the Phase [II] interim results," "expressly cautioned investors not to draw conclusions about the Phase [II] study until its completion," and merely said that the interim results were one of a number of factors leading Wyeth to proceed to the next phase.[317] More literally, the court rejected reading the May 2007 release in light of the October 2006 comment because the latter concerned the need for "spectacular" interim Phase II results in order to proceed to Phase III in the *first* half of 2007, while the former announced initiation of Phase III in the *second* half of that year.[318]

The Sixth Circuit was similarly unpersuaded by the argument that the October 2006 statement created an ongoing duty to disclose, ruling particularly that the issuer had no duty to update that statement.[319] The court reaffirmed that "a duty to update applies only in 'narrow circumstances' involving more fundamental corporate changes such as mergers, takeovers, or liquidations, as well as when subsequent events produce an 'extreme' or 'radical change' in the continuing validity of the original statement"—none of which were involved here.[320] Further, "there is no duty to update vague and general statements such as 'spectacular.'"[321]

Disclosure of FDA communications and other developments not immediately related to a pending application. Genzyme Corporation produced biologics—chemically synthesized pharmaceuticals requiring contamination-free manufacturing.[322] After originally receiving a biologics license from the FDA in 2006 for a drug called Myozyme, which Genzyme produced in 160-liter bioreactors at a plant in Framingham, Massachusetts, the company disclosed on October 24, 2007 that it had submitted to the FDA a supplemental biologics license application ("BLA") for a version of that same drug to be manufactured in a 2000-liter bioreactor at its facility in Allston, Massachusetts ("2000L Lumizyme").[323] Genzyme also planned to produce the drug in a 4000-liter bioreactor at a Geel, Belgium plant, seeking approval from European regulators for that biologic ("4000L Lumizyme").[324] The company abandoned the 2000L Lumizyme BLA in November 2009.[325]

316. *Id.* at 171–72.

317. *Id.* at 171.

318. *Id.* at 171–72.

319. *Id.* at 176.

320. *Id.* (quoting United States v. Schiff, 602 F.3d 152, 170 (3d Cir. 2010)).

321. *Id.* The court further opined that the May 21, 2007 press release, with its cautionary language, "tempered any impression made by the 'spectacular' statement" and "cut off" any duty to update anyway. *Id.*

322. *In re* Genzyme Corp. Sec. Litig., 754 F.3d 31, 34 (1st Cir. 2014).

323. *Id.* at 34–35. The 2000L Lumizyme BLA was initially "supplemental" to the FDA-approved Myozyme BLA. *Id.* at 35 & n.1. However, the FDA determined that Genzyme would have to submit a full BLA for 2000L Lumizyme. *Id.* at 35.

324. *Id.* at 35. The court referred to the product to be produced in Belgium as 4000L Lumizyme. *Id.* at 38. Myozyme, 2000L Lumizyme, and 4000L Lumizyme apparently were chemically the same, just synthesized in different-sized bioreactors. *See id.* at 34–35. The European Medicines Agency approved 4000L Lumizyme in February 2009. *Id.* at 35.

325. *See id.* at 39.

Investors brought a securities fraud action under section 10(b) of the Exchange Act against Genzyme and certain officers, alleging that the defendants misled investors during the period in which the company sought FDA approval for 2000L Lumizyme.[326] Affirming dismissal of the case, the First Circuit held that the complaint failed to allege facts raising a strong inference of scienter.[327] The court divided the allegations into three categories.[328]

First, the plaintiffs criticized Genzyme for failing, until March 2, 2009, to disclose a Form 483 that the FDA delivered to Genzyme in October 2008 after the FDA inspected the Allston plant in that month.[329] The Form 483 stated that the inspection disclosed variations at Allston from Current Good Manufacturing Practices ("CGMP").[330] However, (i) the Form "made no mention of the [2000L] Lumizyme BLA and it did not otherwise note that the drug's approval process might be jeopardized";[331] (ii) an FDA advisory committee had confirmed 2000L Lumizyme's clinical effectiveness, which Genzyme announced to analysts after receiving, but without mentioning, the Form 483;[332] and (iii) while the FDA, in November 2008, did extend the projected date for 2000L Lumizyme approval from November 2008 to February 2009, the company promptly disclosed that development.[333] As to the March 2, 2009 timing of Genzyme's revelation of the October 2008 Form 483, that disclosure followed an FDA February 27, 2009 Formal Warning Letter and an FDA Complete Response Letter of the same date, together stating that the agency would withhold approval of the 2000L Lumizyme BLA until Genzyme successfully addressed issues raised in the October 2008 Form 483.[334] As the First Circuit saw it, it was only those "latter two communications that crystalized the relevance of the October 2008 Form 483 to defendants' earlier positive statements regarding Lumizyme's approval."[335] Thus, the failure to disclose the Form 483 did not suggest that the defendants' pre-March 2009 optimism about FDA approval of the 2000L Lumizyme BLA was disingenuous, because it was not until late February 2009 that the FDA stated

326. *Id.* at 33–34, 40.

327. *Id.* at 34, 47.

328. *Id.* at 41.

329. *Id.* The FDA sent the Form 483 to Genzyme's CEO, as it was "common protocol for the FDA to present Forms 483 to top management officials." *Id.* at 35. The court described the form as "contain[ing] advisory language that make[s] clear it lists only 'inspectional observations and do[es] not represent a final agency determination regarding [the company's] compliance.'" *Id.* (quoting the form).

330. *Id.* at 35.

331. *Id.*

332. *Id.* at 36.

333. *Id.* In May 2008, the FDA initially provided Genzyme with a targeted approval date (a "PDUFA date," named after the Prescription Drug User Fee Act of 1992) of November 29, 2008. *Id.* at 35. The October 2008 Form 483 did not postpone that initial date. *Id.* at 36. In November 2008 the FDA moved the PDUFA date to February 28, 2009. *Id.* The opinion does not suggest that the FDA, in extending the date, signaled anything other than that it needed more time because the 2000L Lumizyme BLA was more extensive than the agency anticipated. *Id.*

334. *Id.* at 37. Genzyme responded to the Form 483 in October 2008 with a remediation plan, *id.* at 35, and the FDA's February 2009 Warning Letter stated that the agency found that plan wanting, *id.* at 37.

335. *Id.* at 42.

that the observations in that Form 483 would affect that approval. As soon as that became clear, Genzyme disclosed the Form 483, and that quick action—together with the company's prompt earlier announcement of the extended projected FDA approval date for 2000L Lumizyme—"undercut any inference of fraudulent intent on the part of defendants."[336]

Second, plaintiffs claimed that the defendants fraudulently touted 2000L Lumizyme's chances for FDA approval without disclosing—until June 16, 2009—that the Geel plant had suffered a bioreactor failure in September 2008 and that the Allston facility had suffered a similar episode in October 2008.[337] After the Geel failure, Genzyme instituted an internal inquiry to discover the cause of the problem, which was unknown at the time.[338] In November 2008 and March 2009, the company informed investors of "tight" inventories, which were caused (though Genzyme did not say so at those times) by shortages resulting from production declines due to the bioreactor failures.[339] After the Allston plant experienced a second failure, Genzyme revealed all three failures on June 16, 2009, as well as their cause, now determined to have been a rare virus.[340]

The First Circuit again found no strong inference of scienter.[341] As to the problem at Geel, "the bioreactor run failures [there] bore no relation to FDA approval of the [2000L] Lumizyme BLA for production at the Allston plant," and were, in fact, "immaterial" to that approval.[342] As to both the first failure at Allston and the failure at Geel, "it was proper for Genzyme to open an inquiry into the matter, and to wait for a complete picture to become apparent before making any formal announcements."[343] And, as to both of those, "at no point before Genzyme disclosed the results of its internal investigation did the FDA give any indication that the bioreactor run failures would hinder approval of the [2000L] Lumizyme BLA."[344] Because "Genzyme kept the market apprised of supply shortages, [the court was] not compelled to infer that defendants acted with fraudulent intent by taking the time to investigate, and discover, what was essentially unknown to them."[345]

Third, and more generally, the plaintiffs contended that the defendants deceived investors by optimistic statements concerning prospects for FDA approval of the 2000L Lumizyme BLA.[346] The court found that, after the FDA moved the projected approval date in November 2008, Genzyme's statements about the 2000L Lumizyme BLA "were generally optimistic, yet forward looking and certainly

336. *Id.* The court also found the approval by the FDA advisory panel made it "likely [the defendants] believed Genzyme continued to be on the path towards Lumizyme approval." *Id.*
337. *See id.* at 43.
338. *Id.* at 35.
339. *Id.* at 36–37.
340. *Id.* at 38.
341. *Id.* at 43–44.
342. *Id.* at 43.
343. *Id.* at 44.
344. *Id.* at 43.
345. *Id.* at 44.
346. *Id.*

not categorical."[347] The company promptly disclosed "all relevant communications from the FDA"—including a late July 2009 FDA notification that the agency intended to inspect the Allston plant again and a resulting November 2009 Form 483, together with another Complete Response Letter withholding approval of 2000L Lumizyme.[348] Looking at "the complaint as a whole, as well as the allegations individually," the plaintiffs failed to plead a strong inference of scienter.[349]

Significance and analysis. *Genzyme* deserves two comments. First, it highlights the importance of disclosing bad news from the FDA. Even if a life sciences company does not disclose all other facts conceivably relevant to FDA approval of a device or drug, prompt announcement of all negative communications from the FDA that *pertain directly to the device or drug for which approval is pending* provides the company with a powerful argument that it did not intend to deceive. Granted, communications from the agency may be hard to interpret, and a company is not obliged to disclose them all.[350] If a company produces one or more products and applies for approval of another, the relevance of the FDA's statements about current devices or drugs to the application for approval of the new product may be difficult to determine. But once the agency connects the two, the company does well to disclose all the connected communications. With holistic scienter analysis, defense counsel then can paint a picture of a company doing its best to get to investors the information material to the pending application.

Second, companies should not read *Genzyme* too broadly. In particular, a company should be wary of simply disclosing product shortages caused by a plant failure—without disclosing the plant failure itself until the company determines the cause of the failure. In *Genzyme*, the plaintiffs focused on approval of the 2000L Lumizyme BLA. Without knowing the cause of the bioreactor failures, those failures could not be related to the prospects for FDA approval of 2000L Lumizyme. However, if a life sciences company makes statements about its manufacturing reliability in any of its disclosure documents, then omitting to disclose any significant manufacturing failure might not only mislead but arguably contribute to scienter, even if the company—without disclosing the failure—reveals resulting product shortages.

Duty to Disclose

An omission creates liability under the federal securities law only when the defendant had a duty to disclose.[351] In 2014, three notable federal appellate decisions

347. *Id.* at 45.
348. *Id.*
349. *Id.* at 46.
350. *See* Anderson v. Abbott Labs., 140 F. Supp. 2d 894, 902 (N.D. Ill. 2001) ("The history between Abbott and the FDA makes all the undisclosed information, viewed in context, seem fairly inconsequential. An investor with full information would see a series of inspections, Forms 483, negotiations, re-inspections, more Forms 483 and more negotiations. Abbott had also been in, and out of, an FDA monitoring plan. Plaintiffs appear to concede that events prior to March 17 did not require disclosure to that point.").
351. *See, e.g.*, 15 U.S.C. § 77k(a) (2012) (imposing liability for sales pursuant to any registration statement that "omit[s] to state a material fact required to be stated therein"); Chiarella v. United

addressed the duty to disclose. The Second Circuit found a duty to disclose existing environmental violations where the issuer both explained in offering documents the environmental regulations to which it was subject and provided considerable detail on its efforts to comply.[352] The Eleventh Circuit found sufficient evidence of an issuer's duty to disclose merger negotiations when repurchasing stock from a departing employee.[353] The Ninth Circuit held that Item 303(a)(3)(ii) of Regulation S-K does not create a duty to disclose enforceable under Rule 10b-5.[354]

Duty to disclose wrongdoing. JinkoSolar Holdings Co. ("JinkoSolar") operated in China.[355] JinkoSolar offered American Depository Shares on May 13, 2010 and again on November 10, 2010 in registered offerings.[356] JinkoSolar produced photovoltaic products at, among others, a plant in Zhejiang province.[357] The prospectuses stated that JinkoSolar's operations created pollution risks, that Chinese environmental regulations applied to those operations, and that compliance could be costly and fines and penalties for noncompliance potentially significant.[358] The prospectuses also described, in some detail, the efforts that JinkoSolar made to control pollution, including installation of pollution abatement equipment and maintenance of environmental teams that monitored compliance with Chinese environmental rules twenty-four hours a day.[359] And the prospectus said that the authorities had imposed no penalties on the company.[360]

Investors sued JinkoSolar, alleging that these statements in the prospectuses violated sections 11[361] and 12(a)(2)[362] of the Securities Act and section 10(b) of the Exchange Act.[363] Holding that the statements were not misleading, the district court dismissed the complaint.[364] The Second Circuit reversed on the basis that the complaint alleged actionable omissions.[365]

Section 11, section 12(a)(2), and section 10(b) each impose liability for omitting material facts necessary to avoid misleading investors by statements in an issuer's public offering documents.[366] The plaintiffs asserted that on June 8,

States, 445 U.S. 222, 230 (1980) ("[S]ilence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b). . . . But such liability is premised upon a duty to disclose . . . .").

352. *See infra* notes 355–82 and accompanying text.

353. *See infra* notes 383–98 and accompanying text.

354. *See infra* notes 399–448 and accompanying text.

355. Meyer v. JinkoSolar Holdings Co., 761 F.3d 245, 247 (2d Cir. 2014).

356. *Id.* Those shares traded on the New York Stock Exchange ("NYSE"). *Id.*

357. *Id.*

358. *Id.* at 247–48.

359. *Id.* at 247.

360. *Id.* at 248 ("As of December 31, 2009, no such penalties had been imposed on [the company]." (quoting the prospectus for the May offering)); *id.* at 248 n.1 ("As of the date of [the] prospectus, no such penalties had been imposed on [the company]." (quoting the prospectus for the November offering)).

361. 15 U.S.C. § 77k (2012).

362. *Id.* § 77*l*(a)(2).

363. *JinkoSolar*, 761 F.3d at 249 (referencing 15 U.S.C. § 78j(b)).

364. *Id.*

365. *Id.* at 252.

366. 15 U.S.C. § 77k(a) (2012) (imposing liability where "any part of a registration statement [which includes the prospectus] . . . omitted to state a material fact . . . necessary to make the

2010—about three weeks after the May offering—JinkoSolar provided to the Haining City Environmental Protection Bureau ("EPB") a report including a section titled "Existing Problems" that said, among other things, that (i) the Zhejiang plant was "not disposing of hazardous solid waste in accordance with relevant disposal methods, and was emitting high levels of fluorides"; (ii) a chlorine discharge tube was too close to the water into which it emptied; (iii) the HCl concentration in the region around the plant exceeded established limits; (iv) sludge emitted by the plant constituted hazardous solid waste; and (v) the tower that was supposed to absorb acidic mist was only 35 percent efficient in removing inorganic fluorides.[367] In April 2011, the EPB advised JinkoSolar of excessive levels of fluoride in plant waste, and in May 2011, the EPB detected higher than acceptable levels in its waste waters.[368] By September 2011, the local populace had demonstrated outside the plant after fish died in the river adjacent to the facility, and the Chinese government ordered that the plant be closed.[369]

The Second Circuit held that, because JinkoSolar's prospectuses disclosed the cost of environmental compliance and the costs of noncompliance, and further described its pollution control efforts in some detail and in a manner that would reassure investors, JinkoSolar was obligated also to disclose existing substantial compliance problems.[370] Even if all the statements that JinkoSolar made were literally true, they could mislead by omission.[371] Because "the description of pollution-preventing equipment and 24-hour monitoring teams gave comfort to investors that reasonably effective steps were being taken to comply with applicable environmental regulations," the prospectuses could have misled by those statements "if in fact the equipment and 24-hour team were then failing to prevent substantial violation of Chinese environmental regulations."[372] The temporal proximity of the June 2010 report and the May 2010 prospectus, and the characterization in the June report of the problems it described as "existing" in June, was "sufficient, if proven, to allow a trier of fact, absent contrary evidence, to draw an inference that the problems . . . were both present and substantial at the time of the May 13, 2010 offering."[373]

statements therein not misleading"); *id.* § 77*l*(a)(2) (imposing liability in the offer or sale of a security "by means of a prospectus . . . which . . . 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"); *id.* § 78j(b) (imposing liability, in connection with the purchase or sale of any security, for the use of "any manipulative or deceptive device or contrivance" contrary to rules promulgated by the Commission); 17 C.F.R. § 240.10b-5(b) (2014) (imposing liability, in connection with the purchase of sale of any security, for the omission of "a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading").

367. *JinkoSolar*, 761 F.3d at 248 (quoting the complaint).

368. *Id.*

369. *Id.* at 249.

370. *Id.* at 251–52.

371. *Id.* at 250–51.

372. *Id.* at 251.

373. *Id.* The court addressed only the "disclosures of the May prospectus because [its] conclusions . . . applie[d] *a fortiori* to the later repetition of those disclosures" for the November offering. *Id.*

It was only left to determine whether the plaintiffs adequately pled that the omitted facts were material. Here the court applied the technique that evaluates the materiality of present facts that could implicate future financial results according to magnitude of the possible future financial impact and the probability of that impact.[374] Using that technique, "a trier of fact could find that the existence of ongoing and substantial pollution problems—here the omitted facts—was of substantial importance to investors."[375]

Significance and analysis. Critically, *JinkoSolar* recognizes the possible obligation to report violative conduct—even before imposition of any government sanction for that conduct. Critically, too, the obligation was self-triggered. That is, the court found the obligation to disclose noncompliance imposed by the company's description of its efforts to comply.[376] *JinkoSolar* suggests that any issuer risks liability for half-truths if its disclosure documents describe regulations, make detailed comments about compliance with the regulations, yet fail to reveal existing, substantial non-compliance.[377]

Contrast *JinkoSolar* in this regard with *Dailey v. Medlock*.[378] In *Dailey*, the issuer bank stated in a private placement memorandum that its operations were "subject to extensive regulation by federal, state and local governmental authorities and . . . subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of [its] operations."[379] Affirming dismissal of the Rule 10b-5 action in which investors claimed, among other things, that this statement misled because the bank failed to add that it was violating laws and regulations and was being investigated by the Michigan Office of Financial and Insurance Regulation,[380] the Sixth Circuit held that the bank's statement was not only accurate but did not say that it believed it was "in compliance with such laws."[381] The court added that, even if the bank had made "a generic claim of legal compliance, *absent any specifics*, [it would] . . . not require the disclosure of allegedly illegal activities."[382]

Duty to disclose merger negotiations. The plaintiff in *Finnerty v. Stiefel Laboratories, Inc*. ("SLI") left SLI's employ on August 29, 2008.[383] Pursuant to the SLI Employee Stock Bonus Plan ("ESBP"), Finnerty elected, on January 6, 2009,

374. *Id.* at 252 (citing Basic Inc. v. Levinson, 485 U.S. 224, 238 (1988)).
375. *Id.*
376. *Id.* at 250 ("Even when there is no existing independent duty to disclose information, once a company speaks on an issue or topic, there is a duty to tell the whole truth.").
377. *Id.* at 251 ("Although [JinkoSolar] . . . warned of a financial risk to the company from environmental violations, the failure to disclose then-ongoing and serious pollution violations would cause a reasonable investor to make an overly optimistic assessment of the risk. A generic warning of a risk will not suffice when undisclosed facts on the ground would substantially affect a reasonable investor's calculations of probability.").
378. 551 F. App'x 841 (6th Cir. 2014).
379. *Id.* at 848 (quoting the private placement memorandum).
380. *Id.* at 843, 849.
381. *Id.* at 849.
382. *Id.* (emphasis added).
383. 756 F.3d 1310, 1315 (11th Cir. 2014), *cert. denied*, No. 14-687, 2015 WL 1280244 (U.S. Mar. 23, 2015).

(i) to receive his stock distribution from the ESBP, and (ii) to "put" the stock to SLI at the then-current market value of $16,469 per share.[384] Finnerty alleged a violation of Rule 10b-5 on the grounds that SLI failed to disclose to him—before he made his election—that SLI was engaged in merger negotiations.[385] A jury found in his favor and awarded him $1,502,484.90.[386] The evidence at trial showed that (i) in November 2008, a director on the SLI board (who represented The Blackstone Group ("TBG"), which had made a minority investment in the company) advised the Stiefel family (which controlled SLI) that Sanofi-Aventis was interested in acquiring SLI; (ii) on November 26, 2008, the Stiefel family "decided to 'move on' the sale"; (iii) on December 8, 2008, Blackstone Advisory Services ("BAS"), a financial advisor affiliated with TBG, presented to the Stiefel family a plan for marketing SLI for sale; (iv) later in December, the SLI CEO met with the Sanofi-Aventis CEO to discuss "how the two companies could operate together"; (v) on December 30, 2008, SLI hired BAS to advise on a possible sale; (vi) in January 2009, SLI and Sanofi-Aventis executed a nondisclosure agreement and SLI contacted other possible buyers; (vii) this process produced a bid for SLI from Sanofi-Aventis and a bid for SLI by GlaxoSmithKline ("GSK"); and (viii) on April 20, 2009, SLI agreed to be bought by GSK for about $68,515.29 per share, with another $7,186.91 per share possible through an earn-out.[387]

The principal question on the *Finnerty* appeal was whether SLI had a duty to disclose the merger negotiations to Finnerty before Finnerty made his January 6, 2009 election.[388] The Eleventh Circuit held there was sufficient evidence for the jury to find such a duty.[389] The evidence showed that SLI repeatedly and proudly reminded employees that the company was privately held and that, at the time TBG made its minority investment in SLI, SLI issued an August 9, 2007 press release stating "[SLI] . . . will continue to be privately held, and the Stiefel family will retain control and continue to hold a majority-share ownership of the company."[390] The court found that "[t]he jury could have reasonably concluded that the investors who were also SLI employees attached a special significance to the statements that SLI 'will continue to be privately held' because the statements were reinforced by the company's history and longstanding philosophy."[391] Because the jury could also have found that—by the date SLI engaged BAS on December 30, 2008—"SLI considered itself to be a serious acquisition target,"[392] SLI had a duty to update Finnerty, before buying back his SLI

384. *Id.*
385. *Id.* at 1316.
386. *Id.*
387. *Id.* at 1314–15.
388. *Id.* at 1316–20.
389. *Id.* at 1316–20, 1326.
390. *Id.* at 1314.
391. *Id.* at 1318.
392. *Id.*

shares in January 2009, at least to the extent of telling him "that a sale of the company was under consideration."[393]

Significance and analysis. *Finnerty* provides a mishmash analysis. The decision fits well with prior authority that a company has a duty to update a statement about its fundamental nature when events produce a radical change in the company's view.[394] But *Finnerty* puts an odd twist on this line of reasoning by limiting the duty in the case before it to a duty to update employees, not investors generally, and further, only a duty to update those particular employees from whom the company was repurchasing stock. The court reasoned that the company's statements about remaining private could have had special significance to its employees[395]—acknowledging that the "will continue to be privately held" representation might have been, for other investors, "too vague to be consequential,"[396] and disavowing any holding that "SLI had an immediate duty to update the public when the negotiations with Sanofi-Aventis became serious."[397] The court held only "that SLI had a duty to update [its employee] *at least before it repurchased shares of its own stock from him*."[398] Put another way, the court held that the company had a duty update that was limited to a particular set of shareholders under a particular set of circumstances.

Duty to disclose product quality problems. *In re NVIDIA Securities Litigation* required the Ninth Circuit in 2014 to address the relationship of Regulation S-K Item 303 to a Rule 10b-5 claim.[399]

NVIDIA produced highly complex and technical computer graphics and media and communications processor chips.[400] Recognizing the inevitability that some chips will fail, NVIDIA stated in its SEC filings that "[its] products may contain defects or flaws," and that the company "may be required to reimburse customers for costs to repair or replace the affected products."[401] NVIDIA created a reserve from which to reimburse customers when failures occurred.[402]

In September 2006, NVIDIA sought to reduce cracks in chips by switching the solder it used while manufacturing them.[403] The chips manufactured with the new solder, however, proved susceptible to fatigue and to cracking over

393. *Id*. at 1319. The Eleventh Circuit also found evidence sufficient to support the jury's conclusion that the information about a possible sale was material by the January 6, 2009 date on which Finnerty elected to put his stock back to SLI. *Id*. at 1321–22.

394. *See* United States v. Schiff, 602 F.3d 152, 170 (3d Cir. 2010) ("[T]he duty has only been plausible in cases where the initial statement concerns 'fundamental[] change[s]' in the nature of the company—such as a merger, liquidation, or takeover attempt—and when subsequent events produce an 'extreme' or 'radical change' in the continuing validity of that initial statement." (quoting *In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1433–34 & n.20 (3d Cir. 1997))).

395. *Finnerty*, 756 F.3d at 1318.

396. *Id*.

397. *Id*. at 1319.

398. *Id*. (emphasis added).

399. 768 F.3d 1046, 1048 (9th Cir. 2014).

400. *NVIDIA*, 768 F.3d at 1048–49.

401. *Id*. at 1049 (quoting specified filings with the SEC).

402. *Id*.

403. *Id*.

time.[404] NVIDIA and two of its customers—Hewlett-Packard ("HP") and Dell Computer ("Dell")—sought to determine the cause of this problem.[405] At first, NVIDIA attributed the cracking to damage that HP and Dell had done to the chips, or to HP and Dell computer designs.[406] HP, on the other hand, believed that the cracks resulted from thermal cycling, that is, the fluctuation in the temperature inside a computer as its operation first causes the temperature to rise and its fan then causes the temperature to fall.[407] Consequently, HP and Dell issued updates that caused the fans in their computers to run continuously in order to eliminate heat cycling.[408] After further testing, HP concluded that the cracking resulted from the narrow temperature range in which the chips operated, which turned out to be a range in which the new solder experienced particular stress; this concatenation was called the "thermal profile" problem.[409] In May and June 2008, NVIDIA advised its customers that it was returning to the solder it had used before the change in September 2006.[410]

On May 22, 2008, NVIDIA disclosed in its Form 10-Q that "one of our customers asserted claims for incremental repair and replacement costs related to an alleged die/packaging material set defect in one of [our chips which] . . . was included in a significant number of the customer's notebook products that have been sold to end users, and has also been shipped to other of our customers in significant quantities."[411] NVIDIA said that it was "evaluating the potential scope of this situation, including the nature and cause of the alleged defect and the merits of the customer's claim," and was looking into "what extent the alleged defect might occur with other of our products."[412] The company stated that it was "currently unable to estimate the amount of costs that may be incurred by us beyond the normal product warranty accrual that we have taken related to this claim and the alleged defect and, therefore, we have not recorded any additional related costs or a liability in our Condensed Consolidated Financial statements as of, and for the three months ended, April 27, 2008."[413] On July 2, 2008, NVIDIA filed a Form 8-K announcing that it would take "a $150 to $200 million charge to cover warranty, repair, return, replacement, and other costs."[414] The company's stock declined 31 percent.[415]

The plaintiffs claimed that NVIDIA knew the facts behind the defect by November 8, 2007 and sued on behalf of all who bought NVIDIA stock between

404. *Id.*
405. *Id.*
406. *Id.*
407. *Id.* at 1049 & n.2.
408. *Id.* at 1049–50.
409. *Id.* at 1050.
410. *Id.*
411. NVIDIA Corp., Quarterly Report (Form 10-Q), at 20 (May 22, 2008), *available at* http://www.sec.gov/Archives/edgar/data/1045810/000104581008000016/q109form10q.htm.
412. *Id.*
413. *Id.*
414. *NVIDIA*, 768 F.3d at 1050 (quoting NVIDIA Corp., Current Report (Form 8-K), at 2 (July 2, 2008), *available at* http://www.sec.gov/Archives/edgar/data/1045810/000119312508145974/d8k.htm).
415. *Id.* at 1051.

that date and July 2, 2008.[416] They contended that NVIDIA's positive characterizations of its business and financial results during the class period misled investors because the company failed to disclose the product defects at the same time.[417] Affirming dismissal on the basis that the plaintiffs had failed to plead facts raising a strong inference of scienter,[418] the Ninth Circuit made three key holdings.

First, in response to the plaintiffs' argument "that the district court erred by failing to consider their allegations of scienter in the context of Item 303 of Regulation S-K," the court held that violation of Item 303's disclosure duty is not actionable under Rule 10b-5.[419] Item 303(a)(3)(ii) of Regulation S-K requires that a company "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[420] The SEC interprets this Item to require a two-step process.[421] First, the issuer must determine whether a known trend or uncertainty is "likely to come to fruition."[422] Unless the issuer's management determines that this is "not reasonably likely to occur," the issuer must proceed to the second step, which is to "evaluate objectively the consequences of the trend . . . or uncertainty on the assumption that it will come to fruition."[423] Unless management determines that those consequences are "not reasonably likely" to have "a material effect on the [issuer's] financial condition or results of operations," Item 303 requires disclosure of the trend or uncertainty.[424] The SEC specifically stated that this two-step process is *not* the same as the probability/magnitude technique that the Supreme Court endorsed in *Basic Inc. v. Levinson* to determine the materiality of current facts that will impact a company in the future.[425] Accordingly, Item 303 can require disclosure when Rule 10b-5 does not, and Item 303 does not by itself create a duty to disclose, the violation of which imposes Rule 10b-5 liability.[426]

416. *Id.*

417. *Id.* at 1050. For example, NVIDIA filed a Form 8-K on November 8, 2007 stating that "our core businesses are continuing to grow as the GPU [chip] becomes increasingly central to today's computing experience in both the consumer and professional market segments." NVIDIA Corp., Current Report (Form 8-K), at Exhibit 99.1 (Nov. 8, 2007) (press release quoting CEO). As another example, NVIDIA filed an 8-K on February 13, 2008 stating that "Fiscal 2008 was another outstanding and record year for us. Strong demand for GPUs in all market segments drove our growth." NVIDIA Corp., Current Report (Form 8-K), at Exhibit 99.1 (Feb. 13, 2008) (press release quoting CEO).

418. *Id.* at 1065.

419. *Id.* at 1053–54, 1056.

420. 17 C.F.R. § 229.303(a)(3)(ii) (2014).

421. Management's Discussion and Analysis of Financial Condition and Results of Operations, 54 Fed. Reg. 22427, 22430 (May 24, 1989) [hereinafter SEC 303 Release].

422. *NVIDIA*, 768 F.3d at 1055 (quoting the SEC 303 Release, 54 Fed. Reg. at 22430).

423. *Id.* (quoting the SEC 303 Release, 54 Fed. Reg. at 22430).

424. *Id.* (quoting the SEC 303 Release, 54 Fed. Reg. at 22430).

425. *Id.* (citing the SEC 303 Release, 54 Fed. Reg. at 22430 n.27). *Compare id.*, with *supra* note 374 and accompanying text (employing *Basic*'s probability/magnitude analysis).

426. *See NVIDIA*, 768 F.3d at 1055–56.

In its second principal holding, the Ninth Circuit rejected the argument that the many facts the plaintiffs alleged—even when considered holistically—raised a strong inference of scienter.[427] Because the plaintiffs contended that NVIDIA knew all the relevant facts by November 8, 2007,[428] the complaint's arguably most critical allegation asserted that a confidential witness—CW1—stated that (i) HP had identified the "thermal profile" as the cause of the cracking by early 2007, (ii) HP had shared that information with NVIDIA early in that year, and (iii) NVIDIA, by the middle of 2007, had reproduced the test results confirming that cause.[429] Because the plaintiffs incorporated into the complaint by reference a portion of a declaration made by the Director of Engineering and Quality for HP's Notebook Division, the court "consider[ed] the declaration in its entirety,"[430] including the statement that HP had not, until the middle of 2008, determined that the thermal profile caused the cracking.[431] The court found CW1's account "implausible, especially in light of [the HP Engineering and Quality Director's] more-detailed declaration."[432] Moreover, and quite significantly, the Ninth Circuit concluded that, even if CW1's account were credited, it did not "plausibly suggest that NVIDIA must have determined that it was at fault" by mid-2007 nor that NVIDIA "knew at that time (or any time prior to July 2008) that NVIDIA's liability would exceed its normal reserve set aside for costs associated with product failures."[433]

While the complaint included a potpourri of additional allegations based on statements by confidential witnesses, after-the-fact articles, an email from a customer, lawsuits against NVIDIA by its insurers, and the departure of certain NVIDIA officers, the court found none of these to support a strong inference of scienter.[434] Holistically, while "there is some slight support for an inference that NVIDIA knew it was responsible for the problem before its disclosure, and thus acted with intent to deceive at least customers if not investors, a more compelling inference is that NVIDIA did not disclose because it was investigating the extent of the problem, whether it was responsible for it, and if so, whether it would exhaust the reserve."[435]

As its third important holding, the Ninth Circuit declined to apply two pleading heuristics that benefit plaintiffs. The court recognized "the collective scienter (or corporate scienter) doctrine[, by which] . . . it is possible to raise the inference of [corporate] scienter without doing so for a specific individual," and noted that the Ninth Circuit had conceded that it "might be appropriate in some cases."[436] The court specifically referred to a hypothetical in which "General

427. *Id.* at 1056–63.
428. *See id.* at 1051.
429. *Id.* at 1057.
430. *Id.* at 1057–58 & n.10.
431. *Id.* at 1058.
432. *Id.* at 1060.
433. *Id.* at 1059.
434. *Id.* at 1059–63.
435. *Id.* at 1065.
436. *Id.* at 1063 (citing Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736, 743–44 (9th Cir. 2008)).

Motors announced that it had sold one million SUVs in 2006, and the actual number was zero,"[437] and therefore the "company's public statements were so important and so dramatically false that they would create a strong inference that at least *some* corporate officials knew of the falsity upon publication."[438] But the NVIDIA statements "were not 'so dramatically false'" as to create this strong inference.[439] The court also declined to employ the "core operations" doctrine, by which a court "infers that facts critical to a business's 'core operations' or an important transaction are known to a company's key officers."[440] Again, the court stressed that, even if NVIDIA had concluded in early 2007 that the thermal profile was the root of the cracking problem—which appeared to be as far as the core operations pleading protocol could reach here—this would not justify an inference either that NVIDIA had also concluded that it was liable for the cracking or, if it was, that the liability exceeded the defective product reserve.[441]

Significance and analysis. The Ninth Circuit's conclusion that Item 303 does not create a duty to disclose for Rule 10b-5 purposes is correct, but the court's reasoning is not. Rule 10b-5 creates a duty to disclose "a *material* fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[442] That is, the materiality of the omitted fact is necessary to the duty to disclose. Materiality is the key.

The Ninth Circuit relies on a Third Circuit decision holding that "the materiality standards for Rule 10b-5 and [Item 303] differ significantly."[443] The *Basic Inc. v. Levinson* case sets out the one legal standard under federal securities law for 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 a security or deciding how to vote with a security, taking into account whether the fact significantly alters the total mix of information otherwise available.[444] Where a current fact will have an uncertain impact in the future, *Basic* applies this one and only legal definition of materiality through the probability/magnitude technique, by which a court evaluates whether the current fact is likely to be important to a reasonable investor by both the probability that the current fact will have a given impact on the issuer in the future and the magnitude of that impact.[445]

As the Ninth Circuit noted, when the SEC explained the two-step process for Item 303 analysis, the SEC specifically stated that the Item 303 analysis is *different* from the probability/magnitude analysis.[446] Item 303 requires disclosure of a

437. *Id.* at 1063 n.13 (quoting Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 710 (7th Cir. 2008)).

438. *Id.* at 1063 (quoting *Makor*, 513 F.3d at 710) (internal citation omitted).

439. *Id.* (quoting *Makor*, 513 F.3d at 710).

440. *Id.* (quoting S. Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 783–84 (9th Cir. 2008)).

441. *Id.* at 1064.

442. 17 C.F.R. § 240.10b-5(b) (2014) (emphasis added).

443. *NVIDIA*, 768 F.3d at 1055 (quoting Oran v. Stafford, 226 F.3d 275, 288 (3d Cir. 2000)).

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

445. *Id.* at 238; *see id.* at 239, 250 (applying the probability/magnitude analysis to preliminary merger discussions).

446. *See supra* note 425 and accompanying text.

currently known event which could produce a future effect, unless management determines either that (i) the effect is not reasonably likely to occur or, (ii) if it does, the effect is not reasonably likely to be material.[447] In another context, the SEC has stated that a reasonable likelihood does *not* require a greater than 50 percent probability.[448] Consequently, Item 303 could require disclosure of a *current* event that has, say, only a 30 percent chance of producing an effect that—if it occurs—has, say, only a 30 percent chance of being minimally material in the *future*. Put another way, the future possible material effect is not discounted for its probability at all once management concludes that there is any reasonable probability of that effect coming to pass and any reasonable probability that the effect will be material. But application of the probability/magnitude analysis *does* discount the future effect by the full amount of its low 30 percent probabilities and thereby, in this example, would lead to the conclusion that the current event is not material. Thus, the difference between the probability/magnitude analysis and analysis under Item 303 is not that they have different standards of materiality but that Item 303 may require disclosure of current events that are not material at all. It is for that reason that Item 303 does not create a duty of disclosure for purposes of Rule 10b-5.

Putting aside this doctrinal mixup, *NVIDIA* is important because it shows that, when the claim is that the issuer failed to disclose a liability, scienter requires that the issuer knew or was reckless in not knowing (i) the underlying facts creating the problem; *and* (ii) that those facts meant that the issuer was liable; *and* (iii) that the amount of the liability exceeded any relevant reserve. It was the plaintiffs' failure to plead facts raising a strong inference of (ii) and (iii) that resulted in dismissal.

Misleading Representation

To be actionable, a representation must be false or misleading.[449] The Fifth Circuit ruled last year that the use of the term "reserves" could mislead where the issuer did not use it in accordance with industry understanding.[450]

The plaintiffs in *Spitzberg v. Houston American Energy Corp.* sued under Rule 10b-5 after buying stock in a company with an oil-and-gas concession in Colombia, a concession that included land called the "CPO 4 Block."[451] The company's November 2009 slide presentation stated that "CPO 4 Block consists of 345,452 net acres and contains over 100 identified leads or prospects with estimated

447. *See supra* notes 421–24 accompanying text.

448. In adopting the attorney conduct rules—providing that an attorney must make a report to a public company issuer's chief legal officer or CEO, *see* 17 C.F.R. § 205.3(b)(1) (2014), if the attorney becomes aware of evidence "based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur," *id.* § 205.2(e)—the SEC stated that "[t]o be 'reasonably likely' a material violation must be more than a mere possibility, but it need not be 'more likely than not.'" Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296, 6302 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205).

449. *See, e.g.*, 15 U.S.C. §§ 77k(a), 77*l*(a)(2) (2012); 17 C.F.R. § 240.10b-5(b) (2014).

450. *See* Spitzberg v. Houston Am. Energy Corp., 758 F.3d 676 (5th Cir. 2014).

451. *Id.* at 679–80.

recoverable reserves of 1 to 4 billion barrels[.]"[452] Plaintiffs contended that the defendants' use of the term "reserves" in this slide was deceptive because the Petroleum Resource Management System ("PRMS"), adopted by the SEC for filings concerning petroleum reserves, "states that a reservoir of hydrocarbons can only constitute 'reserves' where the 'commercial productibility' of the reservoir is 'supported by actual production or formation tests,'" and there had been—as of November 2009—neither actual production nor any test drilling at CPO 4 Block.[453]

While the district court dismissed the case on other grounds, the defendants argued on appeal that the appellate court should affirm because the plaintiffs failed to adequately allege a misrepresentation.[454] In reversing the lower court,[455] the Fifth Circuit rejected this argument.[456] The defendants pointed out that the slide presentation included no express statement that the company had performed any drilling on CPO 4 Block,[457] and showed that the company had just acquired its interest in the block, thereby conveying that the company had not performed any testing there.[458] The Fifth Circuit responded that (i) the defendant company conducted all its drilling operations through a second company (not a defendant in the case),[459] (ii) the second company had possessed drilling rights at CPO 4 Block since 2008, and (iii) therefore investors "might . . . have believed" that testing by that second company had provided the factual predicate necessary for the reference to "reserves" in the November 2009 presentation.[460] The defendants argued that the slide presentation never said that it was using "reserves" in the manner defined by the PRMS and that the presentation in fact expressly stated it was "us[ing] certain terms in this document, such as nonproven, resource potential, Probable, Possible, Exploration and unrisked resource potential that the SEC's guidelines strictly prohibit us from including in filings with the SEC."[461] But the Fifth Circuit held that this caveat did not expressly cover the term "reserves" because the SEC *does* permit use of that term, "[n]or did the caveat suggest that any terms . . . would

452. *Id.* at 680 (quoting the presentation). On November 9, 2009, the defendants filed a Form 8-K that included a copy of the presentation. *Id.*

453. *Id.* (citing Modernization of Oil and Gas Reporting, 74 Fed. Reg. 2158, 2160 & n.15 (Jan. 14, 2009) (to be codified at 17 C.F.R. pts. 210, 211, 229 & 249) (requiring use of the PRMS reserves definitions in SEC filings, and stating that the PRMS constitutes "a widely accepted standard for the management of petroleum resources developed by several industry organizations")); *id.* at 681 (quoting plaintiffs' filings that relied upon PRMS and reviewing allegations that no production or test drilling had occurred).

454. *Id.* at 689.

455. *Id.* at 693.

456. *Id.* at 689–91.

457. *Id.* at 681.

458. *Id.* at 689–90. In addition, the slide presentation referred to "'2 Exploration Wells' as a 'Work Obligation' during 'Phase 1' . . . '3 Exploration Wells' as a 'Work Obligation' during 'Phase 2' of the project . . . [and a] budget 'through December 2010' . . . , which allocated funding for '2 Well Prep.'" *Id.* at 681 (quoting slide presentation). Defendants argued that no reasonable investor could—given these disclosures—construe the reference to "reserves" at CPO 4 Block to mean that the company had already performed formation testing or produced hydrocarbons from the tract. *See id.*

459. *Id.* at 680.

460. *Id.* at 690.

461. *Id.* (quoting disclaimer included in slide presentation).

be used in a manner that diverged from the common understanding in the industry as allegedly set forth in PRMS."[462]

Significance and analysis. *Spitzberg* demonstrates that securities lawyers experienced in the oil and gas industry should vet all presentations by oil and gas operators selling securities, with particular attention to use of the word "reserves." More generally, issuers and promoters must be keenly aware of industry-specific terms and use them with precision. Otherwise, even what appears to be a carefully crafted caveat may be insufficient to avoid a lawsuit that proceeds beyond the pleading stage to expensive discovery.

Materiality

In *United Food & Commercial Workers Union Local 880 Pension Fund v. Chesapeake Energy Corp.* ("CEC"), the Tenth Circuit provided probably the most interesting opinion on materiality last year.[463] The plaintiff sued under sections 11 and 12(a)(2) of the Securities Act for CEC's failure to disclose in a July 9, 2008 offering that (i) the company had expanded its hedging strategy, and (ii) its CEO had pledged substantially all of his stock as security for margin loans and had no other resources to meet those loans.[464] Affirming summary judgment for defendants, the court held that CEC had omitted no material fact.[465]

The critical hedges were "knockouts" by which a third party and CEC contracted that on some future date CEC would pay the other party the difference between the then-market price of a set amount of natural gas and the fixed price set forth in the hedging contract, if the market price exceeded the contract price; and the third party would pay CEC the difference, if the market price was below the contract price—except that the third party would not have to pay CEC at all if the market price of natural gas was, on the designated date, below a specified "knockout" price.[466] Effectively, the knockout hedges were, from CEC's perspective, "a bet that prices would not drop below the knockout price."[467] While the registration statement and prospectus included information on CEC's hedges and incorporated a Form 10-Q with more information on hedges—including "the volume of knockout swaps Chesapeake had entered into [through March 2008] that would mature in 2008, 2009, and 2010, and . . . the average fixed price and the average knockout price for the contracts"—the plaintiff contended that only after the offering did CEC reveal, in an August 2008 Form 8-K, the increase in knockout hedges and the increase in knockout prices in contracts CEC made between the end of March and the July 9 offering.[468]

462. *Id.* The *Spitzberg* court also found that the complaint adequately alleged the falsity of representations describing the results of drilling at a test well, *id.* at 681–82, 691, and sufficiently pled scienter with respect to all the misrepresentations, *id.* at 683–86.

463. 774 F.3d 1229 (10th Cir. 2014).

464. *Id.* at 1231.

465. *Id.* at 1243.

466. *Id.* at 1234.

467. *Id.*

468. *Id.* at 1235–36.

Leaning on the principle that "[u]ndisclosed information is material only if its disclosure would have 'significantly altered the total mix of information available' to a reasonable investor,"[469] the Tenth Circuit held that CEC disclosed, in a Form 8-K filed on May 2, 2008, "almost all the change in Chesapeake's knock-out-swap hedging . . . before the [July 9] offering date."[470] Although the plaintiff argued that this information should not be considered because it was "not part of the offering materials,"[471] "the May 8-K was readily available on the SEC website, and a reasonable investor interested in Chesapeake's swap practices would know from prior 8-Ks that these disclosures provide the latest information on the subject."[472] While the plaintiff contended that the information in the offering documents should have been updated, "in this circumstance, [the court thought that] the 'total mix' include[d] readily available information providing that update."[473]

Moving to the CEO's margined stock, the Tenth Circuit noted that the July 9, 2008 offering documents incorporated a definitive proxy statement on Schedule 14A filed on April 29, 2008.[474] That proxy statement had, in compliance with Item 403(b) of Regulation S-K, stated that the CEO owned 29,529,975 CEC shares, of which 29,332,493 "were 'held in bank or brokerage margin accounts or escrow accounts securing brokerage accounts.'"[475] Observing that, as the price of CEC stock changed, so would the number of shares in the margin accounts that constituted collateral, the Tenth Circuit concluded that, by listing the *total* number of shares in the margin accounts without stating how many were pledged as collateral, CEC could not have made "a *material* omission because, if anything, [the disclosure] provided an excessive warning of risk by overstating the number of collateralized shares."[476] The plaintiff contended as well that CEC had a duty to disclose that the CEO had no personal resources to meet margin calls to which he would be subject should the price of CEC stock significantly decline.[477] But the Tenth Circuit found that no such information was needed to correct any statement in the offering documents as they "contain[ed] no representation of [the CEO's] capacity to cover margin calls with his financial resources,"[478] and further found that "[t]he risk of margin calls and the consequent need of the

469. *Id.* at 1237–38 (quoting Slater v. A.G. Edwards & Sons, Inc., 719 F.3d 1190, 1197 (10th Cir. 2013)).

470. *Id.* at 1237.

471. *Id.*

472. *Id.* at 1238.

473. *Id.* at 1239.

474. *Id.* at 1239–40; *see* Chesapeake Energy Corp., Definitive Prospectus Supplement (Form 424B2), at S-29 (July 9, 2008), *available at* http://www.sec.gov/Archives/edgar/data/895126/000119312508149333/d424b2.htm#supptoc34971_9.

475. *Chesapeake Energy*, 774 F.3d at 1239–40 (quoting the Schedule 14A).

476. *Id.* at 1241. The importance of the collateralization was twofold: (i) that the CEO might take unwarranted risks to keep the CEC stock price up and so avoid margin calls attendant upon a drop in that price, and (ii) that the CEO might have to dump the stock in the margin accounts to meet margin calls, thereby precipitating a market reaction to a large insider sale. *See id.*

477. *Id.* at 1242.

478. *Id.*

owner of the stock to sell shares is obvious."[479] Thus, "[n]o purpose would have been served by 'disclosing' that [the CEO] might have to sell a large portion of the margined stock if the bottom dropped out of the market."[480]

Scienter and Pleading Scienter

To be successful on a Rule 10b-5 claim, the plaintiff must plead and prove that the defendant had scienter—defined by the Supreme Court as "a mental state embracing intent to deceive, manipulate, or defraud,"[481] and expanded by all courts of appeals to include some form of extreme recklessness with respect to misleading investors.[482] The Exchange Act requires that the complaint "state with particularity facts giving rise to a strong inference that the defendant acted with [this] required state of mind."[483] To satisfy the statutory pleading standard, the facts alleged in the complaint, together with judicially noticeable material, must raise an inference of scienter that is "cogent and at least as compelling as any opposing inference of nonfraudulent intent."[484] In 2014, the Sixth Circuit authored an important decision addressing how to plead the scienter of a corporation, but determined in the case before it that plaintiffs had failed to allege facts creating a strong inference of corporate scienter.[485] The Ninth Circuit applied its "core operations" doctrine that simplifies pleading where the subject matter of the alleged fraud concerns matters of such importance that executives are presumed to know about them—substantially reversing a dismissal as a result.[486]

Corporate scienter. When the plaintiff sues a corporation, the plaintiff must plead and prove that the corporation, as an entity, had scienter. *In re Omnicare, Inc. Securities Litigation* provided the Sixth Circuit's view of how entity scienter might be pled.[487] The plaintiffs alleged that Omnicare violated Rule 10b-5 in the period between January 10, 2007 and August 5, 2010[488] because

> (i) its CEO said, at a healthcare conference, that Omnicare's "goal is to comply with all laws and regulations" and that he was "pleased to report that [Omnicare is] getting . . . [beyond] matters [of prior regulatory violations],"[489] and (ii) its Forms 10-K said that "[Omnicare] believe[s] that [its] billing practices materially comply with

479. *Id.*
480. *Id.* The court added "that '[i]t is not a violation of any securities law to fail to disclose a result that is obvious even to a person with only an elementary understanding of the stock market.'" *Id.* (quoting Newman v. L.F. Rothschild, 651 F. Supp. 160, 164 (S.D.N.Y. 1986) (quoting Vaughn v. Teledyne, Inc., 628 F.2d 1214, 1220 (9th Cir. 1980))).
481. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). The Court reserved judgment on whether recklessness established scienter under Rule 10b-5. *Id.*
482. 8 Louis Loss et al., Securities Regulation 150 n.544 (4th ed. 2012).
483. 15 U.S.C. § 78u-4(b)(2)(A) (2012).
484. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).
485. *See infra* notes 487–511 and accompanying text.
486. *See infra* notes 512–45 and accompanying text.
487. 769 F.3d 455 (6th Cir. 2014).
488. *Id.* at 460–61.
489. *Id.* at 464 (quoting complaint, which quotes Omnicare's CEO).

> applicable state and federal requirements" and that "[Omnicare] believe[s] that [it is] in compliance in all material respects with federal, state and local laws."[490]

The plaintiff contended that these statements were false or misleading because three internal audits of pharmacy facilities conducted by the company's Vice President of Internal Audit ("VPIA") showed that the facilities submitted false reimbursement claims and claims without proper documentation.[491]

The Sixth Circuit's opinion includes three key holdings. First, recognizing that all the statements were opinions and acknowledging that previous circuit authority required that, to be actionable, an opinion must be both objectively false and subjectively disbelieved, the court abandoned this dual requirement, holding that an opinion is false or misleading if objectively so—thereby "sav[ing] all subjective inquiries for the scienter analysis."[492] The statements were material because, given the company's recent history of compliance problems, "a reasonable jury could find that any information showing compliance problems for Omnicare—arguably in conflict with Omnicare's statements in the Form 10-K submissions—would change an investor's mind about whether to buy or sell stock in Omnicare."[493] And the internal audits showed that the statements were objectively false as the audits showed violations of numerous statutes and regulations and the submission of false claims.[494]

Second, the appellate court held that the complaint did not plead the scienter of any of the individual defendants.[495] The complaint's conclusory allegation—that "[o]n information and belief" the results of one of the audits reached the individual defendants—lacked "any specific facts to explain the basis for [the] belief," as required by the statutory pleading standard.[496] While the plaintiff pled that the VPIA "shared . . . the results" of one of the audits (the "Pharmacy Audit") with the CEO defendant, the complaint never alleged with specificity "what those results were."[497] Although the plaintiff argued that whatever information the VPIA gave the CEO was sufficient to show that the CEO knew the falsity of the statements in the Forms 10-K, the Sixth Circuit agreed with the district court that the complaint failed to meet the statutory requirement for specificity because the plaintiff did not allege "with particularity what the specific results of the [P]harmacy [A]udit demonstrated or what was communicated to [the CEO], i.e.[,] how many pharmacies were involved, what specific irregularities

490. *Id.* (quoting complaint, which quotes Omnicare's filings with the SEC).

491. *Id.* at 462.

492. *Id.* at 471. The Supreme Court granted certiorari and addressed this question in another case involving Omnicare. On the question of when an opinion is false, the Court's analysis in that case supercedes the analysis in the Sixth Circuit's 2014 *Omnicare* opinion. *See* Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318 (2015).

493. *In re Omnicare*, 769 F.3d at 478.

494. *Id.* at 478–80. The court added that, to the extent that Omnicare had made the statements before the audits were completed, a jury could have found that the company had a duty to correct the statements once the audit results were in hand. *Id.* at 480–81. And, further, the court attributed no importance to the circumstance that the company phrased the representations as "beliefs." *Id.* at 479.

495. *Id.* at 481–83.

496. *Id.* at 481–82.

497. *Id.* at 482 (quoting the complaint).

were found, how many actual claims were involved, or how, or what, information was actually communicated."[498]

Third and most important here, the court addressed corporate scienter. The Sixth Circuit rejected the idea that a plaintiff can establish scienter by pleading the mental state of *some* employee—no matter how remote from the allegedly fraudulent statement.[499] Instead, the court held that:

> The state(s) of mind of any of the following are probative for purposes of determining whether a misrepresentation made by a corporation was made by it with the requisite scienter under Section 10(b): . . .
>
> a. The individual agent who uttered or issued the misrepresentation;
>
> b. Any individual agent who authorized, requested, commanded, furnished information for, prepared (including suggesting or contributing language for inclusion therein or omission therefrom), reviewed, or approved the statement in which the misrepresentation was made before its utterance or issuance; [or]
>
> c. Any high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance.[500]

The plaintiff urged that corporate scienter could be established by three executives' "actual knowledge" of the results from the three internal audits.[501] The court held that such knowledge could not be imputed to Omnicare through the first of the three executives "because the Complaint states that [he] served as Chief Compliance Officer only 'through 2008,' meaning that he could have left the company before [the VPIA] conducted the [third internal audit]," and the plaintiff never alleged that the VPIA "shared the results" of the second audit with the former CCO.[502] The knowledge of a second executive—the COO—was "out of bounds under [the court's] conception of collective scienter because there [were] no allegations that [he] played any role in formulating the Form 10-K statements or that he knew of the results of the [second and third internal audits]."[503]

The court held that the plaintiff could attribute the knowledge of the third executive—the VPIA—to Omnicare for purposes of scienter analysis because

498. *Id.* (quoting *In re* Omnicare, Inc. Sec. Litig., No. 11-cv-173-DLB-CJS, 2013 WL 1248243, at *10 (E.D. Ky. Mar. 27, 2013). Similarly, although the complaint alleged that the company's Chief Compliance Officer ("CCO") "brought *compliance related concerns* to the attention of [the CEO] and other Omnicare executives," *id.* (emphasis added by the court) (quoting the complaint), the complaint "failed to elaborate—at all—upon the nature of the concerns that [the CCO] relayed to [the CEO]," and, "[m]ore importantly, . . . failed to provide any specifics regarding the timing of this conversation," *id.* at 483.

499. *Id.* at 475–76 ("If the scienter of any agent can be imputed to the corporation, then it is possible that a company could be liable for a statement made regarding a product so long as a low-level employee, perhaps in another country, knew something to the contrary.").

500. *Id.* at 476 (quoting Patricia S. Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter*, 2006 Colum. Bus. L. Rev. 81, 135).

501. *Id.* at 483.

502. *Id.* (quoting the complaint).

503. *Id.*

he allegedly furnished information for, and reviewed, the challenged statements.[504] Against such attribution, the court weighed (i) the "disparity between the levels of generality at which the internal reports and the external statements [were] framed" (presumably referring to the very general nature of the public professions of belief that the company was complying with the law versus granular results of audits of specific pharmacy facilities); (ii) the "large time lapse between Omnicare's legal-compliance statements"[505] and the revelation of the facts suggesting they were wrong (through a *qui tam* action that the VPIA filed in June 2010[506] and that was dismissed as to its fraud claims on November 20, 2012[507]); (iii) the fact that Omnicare's statements in its Forms 10-K were "not made in the shadow of on-going litigation";[508] and (iv) the company's vigorous defense of the *qui tam* action.[509] Putting it all together, the court found no inference of scienter, and affirmed the district court's dismissal of the case.[510]

Significance and analysis. The court's analysis of corporate scienter proves unhelpful. First, it merely purports to identify individuals whose knowledge is "probative." Indeed, in applying the protocol to the case at hand, the court found the knowledge of a vice president "probative," then proceeded to hold—in light of other facts that were not connected directly to any particular individual at Omnicare who was responsible for the challenged statements—that the plaintiff failed to satisfy the "strong inference" standard for alleging the Rule 10b-5 mental state of the company. Second, the rule that the mental state of some officer or employee who did not write the statement should count—if that individual "furnished information for" the statement—is ambiguous. In a case involving allegedly false financial numbers, even a low level sales associate submitting backdated contracts might be said to "furnish information for" the financial statements that the company publishes. Under the Sixth Circuit rule, the company might have scienter as to the false sales numbers, even if the company had in place well-crafted systems—implemented under the direction of, and monitored by, top officers and designed to catch backdated documents—that failed to identify the particular backdated contracts that the sales associate prepared.[511]

Core operations. In some instances, courts find that the significance of the omitted or misrepresented fact involves matters so important to the issuer that pleading the true facts behind the misrepresentation or pleading the omitted fact—together with specifics showing the importance of the matter to the

504. *Id.*
505. *Id.* at 484.
506. *See id.* at 463; Omnicare, Inc., Annual Report (Form 10-K), at 73 (Feb. 23, 2012) (reporting that the VPIA's *qui tam* suit, which was originally filed under seal, had been unsealed by the court on June 11, 2010).
507. *In re Omnicare*, 769 F.3d at 463.
508. *Id.* at 484.
509. *Id.*
510. *Id.*
511. The Sixth Circuit said that its protocol "allow[s] courts to examine only the states of mind of lower-level employees connected to the statements." *Id.* at 477.

issuer—suffices to raise a strong inference that the issuer and certain of its executives intended to mislead or were at least severely reckless with regard to the truth when they made the false statement or failed to reveal the omitted information. The Ninth Circuit employs several versions of this "core operations" analysis, and used them last year in *Reese v. Malone*, where the appellate court substantially reversed, but affirmed in part, a judgment that the district court entered after granting a motion to dismiss.[512]

BP p.l.c. ("BP") operated three pipelines at Prudhoe Bay.[513] Two of them leaked in 2006—one in the Western Operating Area ("WOA"), where the company discovered a spill on March 2, and one in the Eastern Operating Area ("EOA"), where the company discovered a spill on August 5 and 6.[514] Investors[515] brought a Rule 10b-5 action, claiming that BP's Greater Prudhoe Bay Performance Unit Leader ("GPBPUL"), BP's CEO, and BP itself (in its 2005 annual report) made false and misleading statements about the pipelines, BP's maintenance of them, and compliance with environmental laws.[516]

The court's analysis proceeded statement by statement. On March 15, 2006, approximately two weeks after the first spill, the GPBPUL told the Associated Press that a September 2005 inspection had disclosed corrosion in the WOA pipeline but that such corrosion "appeared to be occurring at a 'low manageable . . . rate.'"[517] The court found that the complaint pled falsity by allegations that the 2005 inspection showed an annual corrosion rate of 32 mills (thousands of an inch) per year ("MPY")—a dramatic increase over the 3 MPY found in 2004 and in the most severe category (over 30 MPY) in BP's internal classification system for corrosion.[518] As to the GPBPUL's scienter, the Ninth Circuit ruled that, "given her position" and the "focus of both public and government inquiries after the March 2006 spill," the GPBPUL "had every reason to review the results of [the company's] corrosion monitoring to understand what happened" and that "[e]vidence of high levels of corrosion would be central to [that] inquiry."[519] Moreover, the fact that she "addressed corrosion rate data specifically, render[ed] it unlikely that she was not aware of it or the concerning aspects of the

512. 747 F.3d 557, 563, 581 (9th Cir. 2014).

513. *Id.* at 563.

514. *Id.* at 563–64.

515. The district court dismissed claims by purchasers of BP's ordinary shares, who did not appeal; the only investors who appealed were purchasers of BP's American Depository Receipts ("ADRs"). *Id.* at 563 n.1.

516. *Id.* at 563 (explaining that plaintiffs brought suit under Rule 10b-5 and sections 10(b), 18, and 20(a) of the Exchange Act, providing a general description of misrepresentations, and identifying the individual defendants); *id.* at 567 (listing the alleged misrepresentations).

517. *Id.* at 569 (quoting GPBPUL's statement to the Associated Press).

518. *Id.* In addition, plaintiffs alleged that their expert opined that thirty-two MPY constituted a "high" rate of corrosion that was "not manageable." *Id.* The court also held that the falsity was material. *Id.* at 570. Although "the spill itself certainly raised public skepticism with respect to BP's pipeline maintenance and corrosion monitoring practices, disclosure of the fact that the company ignored troubling warning signs may have altered the 'total mix' of information available to investors." *Id.* (quoting Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1976)).

519. *Id.* at 571.

company's findings."[520] And she had a motive to mislead, as "revelation that BP ignored red flags would portend serious corporate mismanagement, a portent that would be detrimental both to BP and to [the GPBPUL] personally, as head of the Prudhoe Bay Unit responsible for the spill."[521]

The court turned next to two statements concerning differences between the WOA and EOA lines. The GPBPUL stated, on March 15, 2006 (shortly after the first spill on the WOA line), that "the highly corrosive conditions were unique to that line," and said, on May 14, 2006, that "none [of the other lines] has the same combination of factors . . . bacteria in the facility, low flow rate and low corrosion inhibitor carry over."[522] The Ninth Circuit concluded that the plaintiffs sufficiently alleged that these statements were false by pleading: (i) an admission by a BP Vice President of Regulatory Affairs and Compliance, shortly after the second spill, that "the causal factors that appear to most strongly influence pitting corrosion" were present in both pipelines; (ii) an April 2007 letter from a regulator saying that "the primary cause" of both spills was corrosion "promoted by the particular operating and internal characteristics of the WOA and EOA pipelines, including, but not limited to, [a] low crude oil flow velocities; [b] the corrosivity of the material transported; [c] the presence of water and sediments; [d] an ineffective corrosion inhibitor program; and [e] a lack of maintenance"; and (iii) a September 2006 memorandum to prepare BP officials for congressional testimony that referred to "a certain amount of similarity between the WOA and EOA . . . pipelines" and "similar conditions" at each.[523]

As to the GPBPUL's scienter, the court first noted the facts that the GPBPUL had at least *available* to her at the time she made the statements contending that the WOA and EOA lines were different. A Corrective Action Order ("CAO") delivered to her by a federal regulator on March 15, 2006 (apparently before the GPBPUL's statement on that date) stated that both the WOA and the EOA lines were "constructed around the same time, operate[d] in similar environmental conditions, transport[ed] the same quality crude oil that contributed to the cause of the internal corrosion in PBWOA, and [were] operated and maintained in a similar manner."[524] Moreover, the September 2006 memorandum to prepare BP officials for congressional testimony indicated that BP took account of the similarities between the two pipelines in constructing a testing regime for the EOA line.[525] The district court, nevertheless, found that the complaint deficient because it failed to plead facts sufficient to show that the GPBPUL not only had these facts available but was "herself . . . *aware* of information making her statements false."[526]

520. *Id.* at 572. More generally, as regional leader, the GPBPUL "was directly responsible for the WOA and EOA operations" and would "not only . . . be aware of corrosion problems, but . . . would be among the first to know." *Id.*

521. *Id.* at 571.

522. *Id.* at 573 (quoting GPBPUL's statements to the Associated Press and a trade publication).

523. *Id.* (quoting the referenced sources).

524. *Id.* at 574 (quoting the CAO).

525. *Id.* at 574–75.

526. *Id.* at 575 (emphasis added).

To address this difficulty, the Ninth Circuit turned to its "core operations" analysis.[527] According to that analysis, knowledge of problems with "core operations" can be imputed to an officer who spoke or wrote challenged statements in any of three ways: (i) holistically to bolster the inference of an officer's scienter derived from allegations more directly tying the information to that officer; (ii) independently to satisfy the strong inference requirement, where the complaint alleges the problems with "core operations" specifically and alleges that an officer "'had actual access to the disputed information'"; and (iii) "in rare circumstances . . . , without accompanying particularized allegations, where the nature of the relevant fact[s are] of such prominence that it would be 'absurd' to suggest that management was without knowledge of the matter."[528] Here, the court relied on the second and third protocols. Employing the third version of this imputation, the Ninth Circuit found it "absurd"—given that the CAO was directed to her, given her active role in communications to the press on the spills, and given the fact that she was "overseeing operations in the area where the spill took place"—that she did not have "knowledge that it would be deliberately reckless to make those [materially misleading] statements [distinguishing between the WOA and EOA lines] in March and May of 2006."[529] The objective similarity between the lines, on which BP had relied in determining how to test them for corrosion, and the "paucity of inspection data on the EOA line in light of the fact that it had not been [tested by the most reliable method of finding corrosion] in 16 years" was, in the appellate court's view, "the epitome of 'core' to pipeline operations at Prudhoe Bay."[530] The court also relied on the second version of its "core operations" pleading protocol, reasoning that the GPBPUL's "statements are specific and reflect her access to the disputed information."[531]

Moving to an April 25, 2006 statement by the BP CEO that the first spill, which was discovered on March 2, "occurred 'in spite of the fact that we have both world class corrosion monitoring and leak detection systems, both being applied within regulations set by the Alaskan authorities,'" the court found the plaintiffs alleged falsity "based on the results of later investigations revealing that the pipelines were under-inspected, under-maintained, and subject to severe risk of corrosion-related failure."[532] But the Ninth Circuit found the complaint failed to adequately allege scienter, because no "specific facts support[ed] an inference that [the CEO] had 'actual access'" to contrary information "when he made his statement," which was only about a month after the spill.[533] The Ninth Circuit did

527. *Id.* at 575–77.
528. *Id.* at 575–76 (quoting *In re* Daou Sys., Inc., 411 F.3d 1006, 1023 (9th Cir. 2005)).
529. *Id.* at 576.
530. *Id.*
531. *Id.*
532. *Id.* at 577 (quoting the BP CEO's statement to the press).
533. *Id.* Indeed, the BP board was not briefed in detail about the spill until after the CEO made this statement. *Id.*

not—as to this statement—specifically apply the other two versions of its "core operations" analysis.

Finally, the appellate court turned to a statement in the BP 2005 Annual Report, issued on June 30, 2006—after the first spill but before the second.[534] That report said: "Management believes that the Group's activities are in compliance in all material respects with applicable environmental laws and regulations."[535] While the opinion does not say so, "Group" referred to BP p.l.c. and its subsidiaries,[536] with operations all over the world.[537] The Ninth Circuit found the complaint pled falsity by, among other things, alleging (i) a 2007 BP guilty plea to a Clean Water Act violation, where BP admitted that it was aware, in 2005, of corrosion in the WOA pipeline and admitted it had "insufficient inspection data" on the EOA pipeline, and (ii) the circumstance that BP was not, at the time it issued the 2005 Annual Report, complying with the CAO delivered to the company on March 15, 2006.[538] The appellate court recognized that the statement was phrased as a "belief" and included a materiality qualifier,[539] but held that opinions can be actionable under the securities laws and effectively found that the complaint pled objective falsity[540] as well as subjective falsity.[541] The court then applied the third and most extreme version of the "core operations" analysis by "find[ing] it 'absurd' that management was not aware of BP's significant, existing compliance issues that rendered the statement [expressing belief in material compliance] misleading."[542]

Significance and analysis. The automatic imputation of knowledge, regarding severe difficulties in "core operations," to executives in the third and most far-reaching version of the Ninth Circuit's "core operations" pleading protocol is disturbing. It can always seem, after the fact, that executives "must have known" about problems in the company. Depending on a court's recognition of

534. *Id.* at 577–80.

535. *Id.* at 577 (quoting the 2005 Annual Report).

536. BP p.l.c., Annual Report (Form 20-F), at 5 (June 30, 2006).

537. *Id.* at 22 ("Our Exploration and Production business includes upstream and midstream activities in 26 countries, including the USA, UK, Angola, Azerbaijan, Canada, Egypt, Russia, Trinidad, and locations within Asia Pacific, South America and the Middle East. Upstream activities involve oil and natural gas exploration and field development and production. Our exploration programme is currently focused around the Deepwater Gulf of Mexico, Angola, Trinidad, Egypt, Algeria and Russia. Major development areas include the Deepwater Gulf of Mexico, Azerbaijan, Algeria, Angola, Egypt and Asia Pacific. During 2005, production came from 22 countries.").

538. *Reese*, 747 F.3d at 578; *see id.* at 565–66 (discussing the company's noncompliance with the CAO and its 2007 guilty plea to a violation of the Clean Water Act).

539. *Id.* at 579.

540. *Id.* ("Here, the violations of environmental law were egregious—BP had just spilled over 200,000 gallons of oil onto the Alaskan tundra in violation of the Clean Water Act. Its corrosion monitoring and leak detection systems fell below industry standards and state requirements.").

541. *Id.* ("Based on the pled facts, it is unclear how BP's management could consider the company to be 'in compliance' or, alternatively, could view the violations to be immaterial."). The Ninth Circuit previously held that both objective and subjective falsity are required in order that an opinion be actionable under the securities laws. *See* Rubke v. Capitol Bancorp Ltd., 551 F.3d 1156, 1162 (9th Cir. 2009). As set out above, the Supreme Court, in 2015, addressed the manner in which to evaluate whether opinions are false or misleading for securities law purposes. See *supra* note 492.

542. *Reese*, 747 F.3d at 580.

human fallibility and the difficulties of transmitting information in organizations, it can even seem "absurd" that executives did not know facts that contradicted their contemporaneous statements. It is only in the extremely rare case that this inference—easily induced by hindsight bias—should be indulged in this most naked form in securities cases, where Congress has expressly required that complaints plead particular facts raising a strong inference that a defendant had scienter.[543]

Beyond the problem that the "core operations" inference is inherently in conflict with the statutory standard, the inference leaves it to the court to determine what constitutes a "core operation."[544] *Reese* adds a particular gloss to this complication. The court applied the "core operations" analysis to statements made not just by BP, and not just by BP's CEO, but to statements made by the GPBPUL. This suggests that, when *any* authorized representative of an issuer (or subsidiary of an issuer) makes a statement, a court might look to the subset of issuer business that that individual supervises, determine what the "core operations" are within that subset of the business, and apply the "core operations" inference to that subset. Courts should be wary of expanding the pleading workaround in this manner.[545]

Loss Causation

A private plaintiff seeking damages for a Rule 10b-5 violation must plead and prove loss causation—i.e., that the alleged fraud caused the plaintiff economic loss.[546] Three federal appellate opinions addressed important aspects of loss causation in 2014. The Second Circuit held that a plaintiff could plead loss causation by alleging a stock price drop following a 2012 announcement that a bank had settled regulatory claims based on its misreporting the rates at which it could borrow in 2007–2009—even though the bank had reported unchallenged rates in 2009–2012.[547] The Fifth Circuit held that a series of disclosures—some of which concededly did *not* provide the truth behind assertedly misleading representations—could together constitute "corrective disclosure" for loss causation purposes and, along the way, confirmed the court's view that a disclosure is corrective if it renders the alleged fraud "more probable."[548] The Ninth Circuit held that Rule 9(b) applies to loss causation pleading.[549]

543. 15 U.S.C. § 78u-4(b)(2)(A) (2012).

544. For example, were the pipelines at Prudhoe Bay a "core operation" for BP p.l.c. for purposes of determining the fraudulent nature of a general statement of material environmental compliance in worldwide operations? *See supra* note 537.

545. Another Ninth Circuit panel declined to find scienter adequately pled through allegations of "core operations" where the asserted fraud consisted of defendants' claims that the company would continue to grow, and the plaintiff pled that elaborate issuer software permitted the defendants to see a decline in the number of medical systems that the company sold. Police Ret. Sys. of St. Louis v. Intuitive Surgical, Inc., 759 F.3d 1051, 1056–57, 1062–63 (9th Cir. 2014).

546. 15 U.S.C. § 78u-4(b)(4) (2012); Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

547. *See infra* notes 550–57 and accompanying text.

548. *See infra* notes 558–75 and accompanying text.

549. *See infra* notes 576–79 and accompanying text.

Loss causation from "stale" misrepresentations. In *Carpenters Pension Trust Fund of St. Louis v. Barclays PLC*, the plaintiffs brought a Rule 10b-5 action against Barclays entities and their former officers based on the settlement of an enforcement action, disclosed on June 27, 2012, in which Barclays admitted to misrepresenting, in daily LIBOR reports, the rates at which it could borrow money during the during period 2007–2009.[550] As to loss causation, the plaintiffs relied primarily on a 12 percent decline in Barclays's stock price on June 28, 2012 —the day after Barclays announced the settlement.[551]

The district court dismissed the case, reasoning that the rates that Barclays reported after 2009 and before the June 27, 2012 disclosure—rates that the plaintiffs did not challenge—"would have supplanted any prior LIBOR-related misinformation."[552] In particular, the district court "found it implausible that an efficient market 'would fail to digest three years of nonfraudulent Submission Rates and other more detailed financial information, and would instead leave intact artificial inflation as a result of fraudulent Submission Rates [in 2007–2009].'"[553] The Second Circuit vacated the dismissal insofar as it was based on the LIBOR allegations,[554] on the ground that, "while Barclays's 2009–2012 submission rates may have provided accurate information about the company's borrowing costs and financial condition for the period 2009–2012, they did not correct the earlier years' misstatements."[555] The court could not "conclude, as a matter of law and without discovery, that any artificial inflation of Barclays's stock price after January 2009 was resolved by an efficient market prior to June 27, 2012."[556]

Significance and analysis. The *Barclays* opinion seems in tune with the Supreme Court's 2014 *Halliburton* decision, where the Court adopted a flexible view of the efficient market.[557] Perhaps this view will supplant the more doctrinaire approach that the district court took in *Barclays*—simply assuming that the market

550. 750 F.3d 227, 229–30 (2d Cir. 2014). The class period extended from July 10, 2007 to June 27, 2012. Gusinsky v. Barclays PLC, 944 F. Supp. 2d 279, 282 (S.D.N.Y. 2013).

Thomson Reuters calculated the London Interbank Offered Rate ("LIBOR") on the basis of bank responses to the question: "At what rate could you borrow funds, were you able to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 am?" *Barclays*, 750 F.3d at 230 (quoting Thomson Reuters). Thomson Reuters published not only LIBOR but the answers that individual banks provided to the question. *Id*. at 230–31. Because the rate at which Barclays could borrow money reflected Barclays's financial health (with a lower rate implying better health), and because Barclays reported lower rates than those it believed it could get, Barclays's reports suggested that the bank was in better financial shape than it was. *Id*. at 231.

551. *Barclays*, 750 F.3d at 233.

552. *Id*. at 234.

553. *Id*. (alteration by appellate court) (quoting *Gusinsky*, 944 F. Supp. 2d at 292).

554. *Id*. at 235, 237.

555. *Id*. at 234.

556. *Id*. ("We agree with the Eleventh Circuit that, in general, '[s]o long as the falsehood remains uncorrected, it will continue to taint the total mix of available public information, and the market will continue to attribute the artificial inflation to the stock, day after day.'" (quoting FindWhat Investor Grp. v. FindWhat.com, 658 F.3d 1282, 1310 (11th Cir. 2011))). The court, however, affirmed the dismissal of claims based on the company's statements regarding its internal controls. *Id*. at 237.

557. *See supra* notes 42–47 and accompanying text.

would correct for prior misrepresentations after publication of correct and more current information.

Individually ambiguous revelations, taken together, constituting corrective disclosure. In *Public Employees' Retirement System of Mississippi v. Amedisys, Inc.*, the Fifth Circuit vacated a district court dismissal where the plaintiffs pled loss causation through a series of revelations that did not explicitly reveal the fraud.[558] The plaintiffs sued under Rule 10b-5, claiming that Amedisys—a home health care provider—and its present and former officers and directors, made a series of statements from August 2, 2005 through September 28, 2010 that were false and misleading because they did not disclose unlawful billing practices by which the company caused its employees to make unnecessary in-home visits in order to hit threshold numbers that increased flat fees that Medicare paid to the company.[559] To satisfy the requirement that they plead loss causation, the plaintiffs alleged that the truth became known through a series of partial disclosures.[560]

The Fifth Circuit read the Supreme Court's *Dura* and *Twombly* decisions as mandating that a Rule 10b-5 complaint must meet "a standard of 'plausibility,' or something beyond the mere possibility of loss causation."[561] To do so in an open market case, a plaintiff "must allege that when the 'relevant truth' about the fraud began to leak out or otherwise make its way into the marketplace, it caused the price of the stock to depreciate."[562] "Relevant truth" for this purpose—at the pleading stage—"simply means that the truth disclosed must make the existence of the actionable fraud more probable than it would be without that alleged fact, taken as true."[563] The relevant truth need not "precisely mirror the earlier misrepresentation," can emanate from any source, and need not be packaged in a single disclosure but instead can correct the falsehood "through a series of partial disclosures."[564] The revelations need not show that the defendants intended to commit fraud by making their representation but need only increase the probability that the representation was false.[565]

With these standards in mind, the court turned to the corrective disclosures that had been pled. An August 12, 2008 Citron Research report questioned Amedisys's billing and accounting, "ending with a statement that 'it [had] not yet conclude[ed]

558. 769 F.3d 313, 319, 326 (5th Cir. 2014).

559. *Id.* at 317.

560. *Id.* at 318–19.

561. *Id.* at 320 (citing Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 346 (2005); Bell Atl. Corp. v. Twombly, 550 U.S. 544, 557–58 (2007)).

562. *Amedisys*, 769 F.3d at 320.

563. *Id.* at 321. In a different decision last year, the Fifth Circuit employed the same rule, holding that an oil and gas company's announcement that it was abandoning drilling at a well constituted a "corrective disclosure" for loss causation purposes because abandonment of the well "certainly [made] it more probable" that the defendants' positive statements about the results of drilling at the well were false. Spitzberg v. Houston Am. Energy Corp., 758 F.3d 676, 689 (5th Cir. 2014).

564. *Amedisys*, 769 F.3d at 322 (citing *In re* Williams Sec. Litig.—WCG Subclass, 558 F.3d 1130, 1140 (10th Cir. 2009); Lormand v. U.S. Unwired, Inc., 565 F.3d 228, 261 (5th Cir. 2009)).

565. *Id.* at 326 (referencing the district court's application of the "actual fraud" standard); *id.* at 324 n.5 ("Semantics aside, we think there is little difference between a showing of actual fraud and actual falsity for purposes of pleading loss causation in a fraud-on-the-market case.").

that Amedisys . . . committ[ed] Medicare fraud, but [it found] many indications that this inquiry need[ed] deeper scrutiny.'"[566] Acknowledging that this report "does not alone make the existence of the actionable fraud more probable than not," the Fifth Circuit held that "it must be considered within the totality of all [the] partial disclosures."[567] Similarly, the September 3, 2009 announcement of the resignations of Amedisys's Chief Operating Officer and its Chief Information Officer could "constitute a portion of the totality that we must consider," even though "nothing in the resignation announcement alone reveals the truth behind earlier misstatements," and the stock price drop occasioned by the resignations "could have simply been a market reaction to sudden news that two key executives had left the company."[568] An April 26, 2010 *Wall Street Journal* article—which reported that (i) according to an analysis by a Yale professor, the numbers of Amedisys's home visits clustered around the thresholds for increased Medicare payments, and (ii) an Amedisys nurse said that home visits were "not always medically necessary"—was not irrelevant even though the statistical analysis was based on previously available public records and could have been incorporated into Amedisys's stock price.[569] The Fifth Circuit found "it plausible that this information was not merely confirmatory" and "plausible that complex economic data understandable only through expert analysis may not be readily digestible by the marketplace" so that "the efficient market" might not have been "aware of the hidden meaning of the [publicly available] Medicare data" before the expert analysis appeared.[570] News of three government investigations into suspected Amedisys's "gaming of the Medicare reimbursement system"—by the Senate Finance Committee (disclosed in a May 12, 2010 *Wall Street Journal* article), the SEC (disclosed in a June 30, 2010 company press release), and the Department of Justice (disclosed in a September 28, 2010 company press release revealing a False Claims Act civil investigative demand)—had to be "viewed together with the totality of the other alleged partial disclosures" even though "generally, commencement of government investigations on suspected fraud do not, standing alone, amount to a corrective disclosure."[571] And a July 12, 2010 company announcement of disappointing second quarter results, later attributed by company executives to distractions and "'behavioral' changes" of employees following the commencement of the investigations, could be related to the falsity of company representations on the theory that "[o]nce Amedisys was placed under the spotlight of government scrutiny for Medicare fraud, its earnings dropped significantly because its employees could no longer continue exploiting Medicare reimbursements."[572] Summing it up, "the 2008 Citron Report, the [CIO] and [COO] resignations, the 2010 WSJ Article and

566. *Id.* at 318 (providing the date of the report); *id.* at 322 (sourcing the quotation).

567. *Id.* at 322.

568. *Id.* at 318 (providing the date of the announcement); *id.* at 322–23 (sourcing the quotations).

569. *Id.* at 318 (detailing the article and quoting the nurse); *id.* at 323 (detailing the court's rationale).

570. *Id.* at 323.

571. *Id.* at 318–19 (detailing the disclosures); *id.* at 323–24 (quoting the court's rationale).

572. *Id.* at 319 (quoting the announcement); *id.* at 324 (quoting the court's rationale).

the . . . governmental investigations, coupled with Amedisys's second quarter 2010 earnings report, collectively constitute and culminate in a corrective disclosure that adequately pleads loss causation for purposes of a Rule 12(b)(6) analysis."[573]

Significance and analysis. *Amedisys* includes three important ideas. First, the notion that partial disclosures can be "corrective" for purposes of loss causation seems reasonable. But the idea that individually insufficient disclosures, such as the resignation of top officers, can be added to a mosaic that holistically discloses falsity should be applied with great care. A fact such as a resignation should only count as corrective of a fraudulent disclosure if the complaint links the resignations to the false statements.

Second, the *Amedisys* holding that a disclosure can be corrective for loss causation purposes if it shows that defendants' statements were false or misleading—even if the disclosure does not show that the defendants deliberately committed fraud in making the statements—also seems sound. The point of loss causation is simply that revelation of the truth respecting the false or misleading statements, or disclosure of the omitted facts that the defendants had a duty to disclose, caused the stock price to drop—whether or not the misrepresentations or omissions were fraudulent. There is at least one exception to this principle. If a plaintiff pleads that the fraud consisted at least in part of concealing management's lack of integrity, without connecting the integrity issue to material operational facts (such as loss of a critical license as a result of management bribes to a government), then a corrective disclosure must indeed reveal (or under the Fifth Circuit's test, render more probable) that the management not only misled or spoke falsely but that the management did so intending to defraud.

Third, the Fifth Circuit's analysis of the April 26, 2010 *Wall Street Journal* article regarding Amedisys's Medicare reimbursements accords with the more flexible view of the efficient market that the Supreme Court adopted in its 2014 *Halliburton* decision.[574] The market may not appreciate the significance of available raw data until that data is processed by analysis. Courts should not automatically assume that the market absorbs the data immediately on disclosure.[575]

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573. *Id.* at 324.

574. *See supra* notes 42–47 and accompanying text.

575. The older, more rigid analysis, however, reared its head in another case in November 2013. Cent. States, Se. & Sw. Areas Pension Fund v. Fed. Home Loan Mortg. Corp., 543 F. App'x 72, 75 (2d Cir. 2013) (holding that the plaintiff improperly relied on "third-party articles and reports express[ing] negative opinions about Freddie's solvency based on information that [was] already publicly available[; s]uch disclosures [were] not 'corrective' for the purpose of pleading loss causation").

Two other loss causation cases deserve mention. The First Circuit provided a detailed analysis of an event study on the way to affirming a trial court order precluding plaintiffs' use of that study and granting summary judgment to the defendants because plaintiffs failed to raise a triable issue as to loss causation. Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse Sec. (USA) LLC, 752 F.3d 82, 91–97 (1st Cir. 2014). The Ninth Circuit held that neither the disclosure of disappointing financial results nor the announcement that the issuer had commenced an internal investigation constituted "corrective disclosures" for loss causation purposes. Loos v. Immersion Corp., 762 F.3d 880, 883, 887–90 (9th Cir. 2014).

Rule 9(b) standards apply in the Ninth Circuit to loss causation pleading. In late 2014, the Ninth Circuit held that "Rule 9(b) applies to all elements of a securities fraud action, including loss causation."[576] The court based its holding on three grounds. First, securities fraud "is derived from common-law fraud," and "Rule 9(b) applies to all circumstances of common-law fraud."[577] Second, Rule 9(b) applies in terms to "the circumstances constituting fraud" and "[l]oss causation is part of [those] circumstances.'"[578] Third, employing Rule 9(b) to review loss causation allegations will "create[] a consistent standard through which to assess pleadings in 10(b) cases, rather than the piecemeal standard adopted by some courts," which use the PSLRA standard for some elements and might use Rule 8 for others and Rule 9(b) for still others.[579]

Extraterritoriality

In *Morrison v. National Australia Bank Ltd.*, the Supreme Court held that Exchange Act section 10(b) applies "only [to (i)] transactions in securities listed on domestic exchanges, and [(ii)] domestic transactions in other securities."[580] The Second Circuit thereafter held that "domestic transactions in other securities" were ones in which "irrevocable liability was incurred or title was transferred within the United States," with irrevocability occurring on the "meeting of the minds."[581] Applying those rules in 2014, the Second Circuit held that Rule 10b-5 did not protect hedge funds that bought a synthetic derivative referenced to a stock that was issued by one foreign company, that was traded on foreign exchanges, and that was allegedly manipulated by false statements made by a second foreign company.[582]

The plaintiff hedge funds purchased securities-based swap agreements that were economically equivalent to short sales of Volkswagen AG ("VW") stock

576. Or. Pub. Emp. Ret. Fund v. Apollo Grp. Inc., 774 F.3d 598, 605 (9th Cir. 2014).

577. *Id.*

578. *Id.* (quoting Fed. R. Civ. P. 9(b)).

579. *Id.* In *Apollo*, the plaintiffs alleged that the defendant issuer, a for-profit educational provider, had falsely attributed its enrollment figures to such benign causes as high quality educational content and teaching, when in fact, the school recruited unqualified students through deceptive practices. *Id.* at 605–06. The Ninth Circuit held that the plaintiffs failed to plead loss causation because they did "not allege specific statements made by the Defendants that were made untrue or called into question by subsequent public disclosures." *Id.* at 608. While the plaintiffs pointed to a Department of Education press release "express[ing] a concern that some students enroll and begin attending classes before completely understanding the implications of enrollment, including their eligibility for student financial aid," the court found that "[a]n expression of concern . . . does not constitute a corrective disclosure and a public admission of Apollo's alleged fraud." *Id.* Plaintiffs' allegation that a report by the Government Accountability Office "'revealed a systemic practice of manipulative and deceptive recruitment practices within Apollo's industry'" did not avail because it "focused on the for-profit education industry as a whole, rather than Apollo and the University of Phoenix." *Id.*

580. 561 U.S. 247, 267 (2010).

581. Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 68 (2d Cir. 2012) (elaborating that "irrevocable liability" includes either purchaser liability "to take and pay for a security" or seller liability "to deliver a security" (citing SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147, 159 (S.D.N.Y. 2011))).

582. Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198 (2d Cir. 2014) (per curiam).

and, accordingly, would yield profits if VW's stock declined and would produce losses if VW's stock price rose.[583] The hedge funds sued Porsche Automobil Holding SE ("Porsche") and two of its officers, alleging that the defendants violated Rule 10b-5 by deliberately making false statements—saying that, although Porsche was buying VW shares, Porsche did not seek to control VW—that induced the hedge funds to buy the swaps and thereby bet on a decline in VW's stock price.[584] When Porsche eventually told the truth—that it *was* seeking control of VW—the price of VW shares shot up, and the hedge funds lost money on the securities swaps.[585]

Although (i) VW shares themselves traded on foreign exchanges (in Germany, the U.K. Switzerland, and Luxembourg) and not on any U.S. exchange,[586] (ii) both VW and Porsche were domiciled in Germany, and (iii) Porsche's assertedly "deceptive conduct occurred primarily in Germany,"[587] the hedge funds "alleged that they entered into the swap agreements referencing VW shares in the United States."[588] Section 10(b) of the Exchange Act applies to transactions in such agreements.[589] Accordingly, mechanical application of *Morrison* and Second Circuit sequels would have applied Rule 10b-5, because the alleged fraud was in connection with the purchase of securities in "domestic transactions"—i.e., security-based swap agreements for which the parties became irrevocably liable in the United States.[590]

The Second Circuit, however, held that, for an off-exchange purchase or sale, *Morrison*'s reference to a "domestic transaction" should be read as a *necessary* condition to application of Rule 10b-5 but not a *sufficient* condition.[591] The court of appeals reached that conclusion because the Supreme Court did not say that domesticity sufficed to bring a purchase or sale within Rule 10b-5's purview, and because applying U.S. securities laws in a case such as this would risk interfering with securities regulation in other countries, with that interference activated "solely because a plaintiff in the United States made a domestic transaction, even if the foreign defendants were completely unaware of it"[592]—a result that Congress could not have intended.[593] Finding that "the relevant actions in this case are so predominantly German as to compel the conclusion that the complaints fail to invoke § 10(b) in a manner consistent with the presumption

583. *Id.* at 205–06.
584. *Id.* at 202–03.
585. *Id.* at 201.
586. *Id.* at 207. The Second Circuit observed that VW ADRs traded in New York, but the swap agreements designated VW shares as the reference security, rather than VW ADRs. *Id.* at 207 n.9. Plaintiffs did not allege that VW shares themselves traded on any U.S. exchange. *Id.* at 207.
587. *Id.* at 207. *But see id.* ("[P]laintiffs allege[d] that some of Porsche's statements denying any intention to acquire control of VW were made into the United States or were available here.").
588. *Id.*
589. 15 U.S.C. § 78j(b) (2012).
590. *See supra* notes 580–81 and accompanying text.
591. *Parkcentral Global Hub*, 763 F.3d at 214.
592. *Id.* at 215.
593. *Id.* at 216.

against extraterritoriality,"[594] the Second Circuit affirmed the district court's dismissal of the complaint.[595]

Significance and analysis. Modern securities markets include a wide variety of sophisticated instruments. As the Supreme Court pronounces rules, straightforward application of those rules may produce results that are clearly wrong when the transactions are more exotic than those familiar to the Justices and their clerks. On occasion, as in *Parkcentral*, lower courts may refine the rules that the Court has articulated. As they do so, they would be wise to follow the Second Circuit's careful lead, as that court pointedly observed that *Parkcentral* stands on its own facts and does not set down a general rule for securities swaps.[596]

Miscellaneous Cases

The Fourth Circuit held that the three-year statute of repose limiting actions under section 11 begins to run when the SEC declares a shelf registration statement effective, rather than beginning to run on the date when the issuer files the supplemental prospectus announcing the offering price.[597] The Second Circuit found that investors in limited partnerships raised a triable issue that they had standing to pursue individual claims, not just derivative claims, where they presented evidence that the manner in which the partnership valued interests held by other limited partners inflated the price that the plaintiffs paid for their interests.[598] The Sixth Circuit held that section 36(a) of the Investment Company Act of 1940 does not create an implied private right of action.[599] Adopting a test that the Fifth Circuit pioneered, the Tenth Circuit found that the SEC adequately alleged that oil and gas ventures—formally organized as general partnerships—were "investment contracts" and, hence, "securities" under federal law.[600]

594. *Id.*

595. *Id.* at 218.

596. *Id.* at 217. The Second Circuit decided three other noteworthy extraterritoriality cases last year. In *United States v. Mandell*, 752 F.3d 544, 549 (2d Cir. 2014) (per curiam), *cert. denied*, 135 S. Ct. 1402 (2015), the court held that a transaction was "domestic" and therefore covered by section 10(b) of the Exchange Act, where the purchasers sent purchase applications and payments to the issuer in the United States, and the issuer had the discretion to accept or reject those applications. In *City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG*, 752 F.3d 173, 179–82 (2d Cir. 2014), the Second Circuit determined that section 10(b) of the Exchange Act did not reach the purchase of a security on a foreign exchange, even though a plaintiff entered a buy order in the United States and even though the security was cross-listed on the NYSE. In *Loginovskaya v. Batratchenko*, 764 F.3d 266, 274–75 (2d Cir. 2014), the court found that a transaction was not domestic, and therefore was outside the reach of section 22 of the Commodity Exchange Act, where the purchaser negotiated and signed the deal in Russia, wire transferred payments to New York, but retained the right to retrieve her funds for fifteen days.

597. Yates v. Mun. Mortg. & Equity, LLC, 744 F.3d 874, 894–98 (4th Cir. 2014), *cert. denied*, 135 S. Ct. 113 (2014).

598. CILP Assocs., LP v. PricewaterhouseCoopers LLP, 735 F.3d 114, 122–27 (2d Cir. 2013).

599. Laborers' Local 265 Pension Fund v. iShares Trust, 769 F.3d 399, 406–09 (6th Cir. 2014), *cert. denied*, 135 S. Ct. 1500 (2015).

600. SEC v. Shields, 744 F.3d 633, 641–48 (10th Cir. 2014) (adopting the approach set forth in Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981)).