Securities Regulation Law Journal

Volume 47 Number 4 Winter 2019

THOMSON REUTERS

Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (July 1, 2019 – September 30, 2019)

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This issue's Survey focuses on the U.S. Securities and Exchange Commission's ("SEC") rulemaking activities and major federal appellate or other decisions relating to the Securities Act of 1933, as amended (the "1933 Act"), the Securities Exchange Act of 1934, as amended (the "1934 Act"), and other federal securities laws from July 1, 2019 through September 30, 2019.

The SEC finalized nine new rules for implementation and proposed five new rules this quarter. While some of the rules relate to technical matters, the focus of the SEC's rulemaking this quarter seems to be on increasing disclosure for retail investors in the brokerage context while streamlining and harmonizing certain compliance obligations in debt and equity capital markets. The key changes are summarized below.

Final Rules

Rule 163B: Solicitation of Interest Prior to a Registered Public Offering

The SEC has finalized Rule 163B which will permit all issuers to make "test-the-waters" ("TTW") communications prior to and after filing a prospectus for a registered offering. Any communication to investors that could be construed as an offer of securities is limited by the "gun-jumping" restrictions of Section 5(c) of the 1933 Act. Currently however, Section 5(d) exempts emerging growth companies ("EGCs") from the prohibitions of Section 5(c) with respect to communications with investors that are qualified institutional buyers ("QIBs") or institutions that are accredited investors ("IAIs"). Now, all issuers will be permitted to make such TTW communications to QIBs and IAIs, without being required to file them separately with the SEC or include any disclaimers or legends in such communications. Rule 163B will go into effect on December 3, 2019.

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The SEC kept the rule largely as set forth in their proposing release. Considered, but rejected, were concerns that TTW communications would be deemed general solicitations and that such treatment would make it more difficult for issuers to complete private placements if they decide not to proceed with a registered offering. The SEC takes the view that TTW communications should be considered on a case-by-case basis and may be considered general solicitations depending on the circumstances of the communication. The SEC also declined to make special accommodations for fund issuers also subject to the Investment Company Act of 1940, as amended (the "1940 Act"). While many private fund issuers issue securities exempt from Section 5 registration pursuant to Section 4(a)(2), those that choose to pursue registration often file a single registration statement under both the 1933 Act and the 1940 Act for greater efficiency. As Rule 163B does not obviate compliance with the 1940 Act, fund issuers will have limited use for the new rule as the SEC rejected suggestions it also create a parallel exemption under the 1940 Act.

However, the SEC did take on board the suggestion from commenters that they strike from Rule 163B proposed anti-evasion language. Commenters worried that such language would have created confusion as to what kinds of communication were permitted, and chill the use of the new rule. The SEC agreed, and noted that QIBs and IAIs had sufficient protection from the treatment of the TTW communications as offers subject to Section 12(a)(2) liability and other anti-fraud provisions including Rule 10b-5 under the 1934 Act. The SEC also agreed to amend Rule 405 to clarify that (in accordance with existing practice) TTW communications under either Section 5(d) or Rule 163B would not need to be filed (whether pursuant to the 1933 Act or the 1940 Act) and would not be treated as free writing prospectuses.

Nonetheless, Rule 163B is to be non-exclusive, and any issuer relying simultaneously on other exemptions must comply with the conditions of any such exemption or rule. Issuers should still expect the SEC staff to review TTW communications made in connection with a registered offering, and should take care to avoid material inconsistencies between TTW materials and the filed prospectus unless new facts and circumstances necessitate changes in company disclosures.

Proposed Rules

Overhaul of Bank Disclosure Rules

The SEC has proposed implementing new rules in Regulation

S-K that would codify and update existing bank regulatory guidance on financial disclosures. Currently, bank holding companies ("BHCs") are subject to the disclosure practices set forth in Guide 3 of the Industry Guides of the 1933 Act and the 1934 Act ("Guide 3") directing the manner in which institutions with material lending and deposit activities describe their business in registration statements for which financial statements are required.

Guide 3 has not been substantively updated since 1986, and the SEC noted that changes in disclosure requirements and accounting standards in the interim have created overlapping disclosure requirements. Moreover, since Guide 3 was promulgated in 1976, many more companies in the financial technology and online lending space engage in activities covered by portions of Guide 3.

The SEC considered proposing rules that would broaden the applicability of the new regulations by focusing on the underlying activities intended to be regulated by Guide 3 rather than addressing the rules to particular types of institutions. Such an approach would extend the reach of Guide 3 beyond BHCs or other lending and deposit institutions. However, the SEC proposes new regulations that continue to address institutions rather than conduct, preferring to maintain greater certainty as to who is subject to the rules and avoid the compliance burden on businesses that undertake some activities similar to those regulated by Guide 3 but that are not BHCs or lending or deposit institutions. Several of the SEC's requests for comment in the proposal are aimed at drawing industry feedback on the appropriate scope and outline of the new rules.

Proposed new Section 1400 of Regulation S-K would remain focused on BHCs, savings and loan associations, and savings and loan holding companies. The SEC is not proposing to expand the scope of Guide 3 to include insurance companies, online lenders or financial technology companies that may undertake some actions similar to those for which Guide 3 is applicable. Further, the SEC is proposing a reduced scope of Section 1400 designed to clean up some inconsistencies that arose with changing accounting standards. In particular, Section 1400 would allow foreign registrants subject to IFRS to exclude certain disclosures not required by such international standards. Guide 3's previous reporting periods (which include five years of certain historical data) would be redefined to sync reporting periods with those required by other applicable SEC rules (e.g., two years of balance sheets and three years of income statements for most registrants). Comments are due on or before December 2, 2019.

Modernization of Regulation S-K: Items 101, 103, and 105

In its April 13, 2016 Concept Release No. 33-10064 (the "Concept Release") on the subject of Regulation S-K, the SEC sought comment on improvements to the effectiveness and relevance of public disclosures, whether by streamlining disclosure requirements, providing greater flexibility to registrants, or discouraging disclosure of immaterial or repetitive information. The SEC now proposes a number of amendments to Items 101 (description of business), 103 (legal proceedings), and 105 (risk factors) of Regulation S-K in an attempt to modernize disclosure.

Proposed amendments to Item 101(a)

Item 101(a) requires a description of the general development of the registrant's business during the past five years, or such shorter period as the registrant may have engaged in business. The SEC has proposed the following changes:

- **Eliminate Mandatory Disclosure Timeframe:** In response to comments on the Concept Release, the SEC has proposed to eliminate Item 101(a)'s five-year disclosure timeframe and Item 101(h)'s parallel three-year time frame for smaller reporting companies. Instead, registrants will be asked to focus on the information material to an understanding of the development of their business, irrespective of a specific timeframe. The SEC argues that registrants should have greater flexibility to determine how best to describe the development of their businesses.
- **Require Only Updated Disclosure in Subsequent Filings:** Many commenters agreed that requiring current registrants to make a full annual disclosure regarding the general development of the business is redundant and inefficient. Initial registration statements under the 1933 Act and the 1934 Act will still require a full description of the general development of the registrant's business. However subsequent filings need only provide an update of the disclosure that addresses any material developments; the initial development of the business disclosure may be incorporated by reference to a hyperlink and need not be restated.
- **List of Proposed Topics**. The SEC proposes to provide registrants a list of topics that may be material to an understanding of a registrant's business development. Among the proposed topics, many commenters opposed the inclusion of a requirement to disclose material changes to a registrant's business strategy. These commenters were concerned that a flat requirement to disclose a registrant's

business strategy could compel registrants to disclose proprietary information in a manner that would create a competitive disadvantage for public registrants in their respective industries. The SEC acknowledged the validity of this argument, and proposes that only registrants that have already disclosed their business strategy shall be required to update their disclosures with material changes to their strategy.

Proposed amendments to Item 101(c)

Item 101(c) requires a narrative description of the business conducted and intended to be conducted by the registrant and its subsidiaries. The SEC noted that although Item 101(c) currently requires that registrants disclose only the enumerated topics that are material to understanding the registrant's business, many registrants misunderstand this and interpret Item 101(c) as requiring disclosure of each enumerated item, even if it is not material. Current language of Item 101(c) therefore can create waste and generate immaterial information that investors must sift through.

In keeping with its desire to create a more principles-based disclosure framework, the SEC has proposed a reduced list of topics for Item 101(c) and intends to direct registrants to exercise judgment as to whether the topics are material for their business and its segments (as applicable).

Proposed amendments to Item 103

Item 103 requires disclosure of any material pending legal proceedings other than routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party, or of which any of their property is the subject. The SEC had been considering eliminating the Item 103 requirement, or referring it to the FASB for potential inclusion via U.S. GAAP. Most commenters opposed that approach. In the proposing release, the SEC retains the disclosure requirements of Item 103, and suggests only two minor updates, one allowing the use of cross references and hyperlinks to refer to applicable litigation disclosures, the other increasing the threshold for disclosure of environmental disputes to adjust for inflation.

Proposed amendments to Item 105 (Risk Factors)

Item 105 requires disclosure of the most significant factors that make an investment in the registrant or offering speculative or risky. The SEC has proposed several revisions to Item 105 that are intended to address the "lengthy and generic nature of the risk factor disclosure presented by many registrants."

- **Summary Page:** In recent years, risk factor disclosures have significantly increased in length, which has added to the complexity of disclosure documents, without necessarily providing additional meaningful information to investors. To combat this, the SEC has proposed to require a summary risk factor disclosure if the risk factor section exceeds 15 pages. The summary would consist of a series of short, concise, bulleted or numbered statements summarizing the principal factors that make an investment in the registrant or offering speculative or risky.
- **Significant vs Material Factors:** In another effort to reduce the length of risk factor disclosures, the SEC has proposed to replace the requirement to disclose the "most significant" factors with only the "material" factors. The SEC believes that this change will focus registrants on disclosing the risks to which reasonable investors would attach importance in making investment decisions, thereby reducing the amount of risk factor disclosure that is not material and potentially shorten the length of this disclosure to the benefit of investors and registrants.
- **Headings:** After soliciting feedback, the SEC received many comments asking to require registrants to separate their risk factors by general and specific disclosures. In response, the SEC has proposed to require registrants to require registrants to organize risk factors under relevant headings, with any risk factors that may generally apply to an investment in securities disclosed at the end of the risk factor section under the caption "General Risk Factors."

The SEC asked for comments to be submitted on or before October 22, 2019.

Publication or Submission of Quotations by Broker-Dealers

On September 25, 2019, the SEC issued a lengthy concept release requesting public feedback on potential amendments to Rule 15c2-11 (the "OTC Rule") of the 1934 Act. The Rule governs the publication and submission of quotations by a broker-dealer in a quotation medium for securities that are not listed on a national securities exchange ("OTC Securities").

The proposed amendments to the OTC Rule seek to better protect retail investors from incidents of fraud and manipulation in OTC securities, by requiring that certain issuer information the broker-dealer is required to review be current and publicly available, while modernizing the Rule to be more efficient and effective. The amendments would require certain minimum information about the issuer and the security be current and publicly available before a broker-dealer can publish a quote for OTC securities. The SEC is also proposing to limit eligibility for an existing exception, commonly known as the "piggyback exception," which allows broker-dealers to publish quotations for a security in reliance on the quotations of another broker-dealer that initially performed the review of the issuer's information. The proposal would also limit the use of the existing unsolicited order exception for quotations on behalf of company insiders if information about the issuer is not current and publicly available. To help broker-dealers, the SEC is proposing amendments to streamline the existing OTC Rule, remove obsolete provisions without undermining the important investor protections of the OTC Rule and make technical, non-substantive changes.

The SEC asked for comments to be submitted on or before 60 days following the date of publication in the Federal Register.

Fifth Circuit Affirms Lower Court's Class Action Dismissal, Finding No Material Misstatements Concerning Inventory Status

On August 19, 2019, the United States Court of Appeals for the Fifth Circuit affirmed the United States District Court for the Northern District of Texas' dismissal of an Amended Complaint in a securities class action brought by Pier 1 Imports, Inc. ("Pier 1") investors ("Plaintiffs") against Pier 1, holding that Pier 1's statements regarding the status of its inventory issues were not materially misleading and thus did not constitute fraud under Section 10(b) and Rule 10b-5 thereunder.

Plaintiffs alleged that through alleged misrepresentations and omissions, Pier 1 failed to inform investors of the "markdown risk" associated with its inventory. Plaintiffs alleged that the misrepresentations and omissions concerned the CFO and CEO's statements that Pier 1's inventory status was "clean," "healthy," and did "not pose a significant immediate markdown risk." Plaintiffs claimed that these statements were misleading because other statements made by the CEO and CFO acknowledged their knowledge of issues with Pier 1's inventory. The alleged statements were (i) statements made at a March 2014 town hall meeting acknowledging that Pier 1 overbought inventory, (ii) statements made directing the company to end the use of temporary storage at stores, (iii) Pier 1's contemporaneous reports on sales figures, inventory, and purchases, and (iv) statements made in Sarbanes-Oxley certifications of SEC filings stating that "the company made conservative inventory purchases." Plaintiffs alleged that as a result of these misstatements and omissions they suffered losses as Pier 1's stock price fell from $18.57 on April 28, 2014, to $4.75 on December 17, 2015. On August 10, 2017, the United States Court for the Northern District of Texas granted Pier 1's motion to dismiss, finding that Plaintiffs failed to plead facts that would support a strong inference of scienter. Plaintiffs were subsequently allowed to amend their complaint but the District Court again granted Pier 1's motion to dismiss on June 25, 2018. Plaintiffs appealed.

The Fifth Circuit affirmed the lower court's decision, finding that Pier 1 repeatedly alerted investors of the inventory issue that would affect its output. The Court stated that Pier 1's knowledge of high inventory did not equate to knowledge of a significant markdown risk. The court further reasoned that even if Pier 1 had such knowledge, knowledge alone would fail to demonstrate an intent to deceive or at least severe recklessness as required to prove scienter. Regarding the specific statements pertaining to the CEO and CFO's knowledge of the inventory issues, the Court reasoned that these statements were made in a public manner and thus were not concealed from Plaintiffs. The Fifth Circuit found that Plaintiffs failed to plausibly allege that Pier 1 made any material misrepresentations concerning its inventory.

Municipal Employees' Retirement System of Michigan v. Pier 1 Imports, Inc., 935 F.3d 424 (5th Cir. 2019).

Northern District of California Dismisses Second Amended Complaint, Finding No Scienter in Misleading Statements without a Guilty State of Mind

On September 18, 2019, the United States District Court for the Northern District of California dismissed plaintiffs' Second Amended Complaint in an action brought against PayPal Holdings, Inc. ("PayPal"), PayPal's purchased entities TIO Networks ULC and TIO Networks USA, Inc. (collectively, "TIO"), and three PayPal Directors and Officers (collectively, "Defendants"), by PayPal investors ("Plaintiffs"), alleging that statements made by Defendants in press releases failed to disclose the seriousness of a security breach on TIO's platform.

On December 6, 2017, Plaintiffs filed a Class Action Complaint on behalf of all persons and entities who purchased or acquired PayPal securities between November 10, 2017, and December 1, 2017, (the "Class Period"), alleging that they purchased PayPal stock at inflated prices after Defendants' publication of allegedly misleading press releases. On November 10, 2017, TIO and PayPal issued press releases concerning TIO's security platform (the "November Press Releases"). The announcement stated, in part, that TIO suspended its operations to protect TIO's customers after PayPal's discovery of security vulnerabilities on TIO's platform. The Press releases also stated that PayPal's platform was not impacted. On December 1, 2017, TIO and PayPal released subsequent press releases stating that a breach had occurred and that the confidential information of 1.6 TIO customers was affected. The press release also reiterated that PayPal's platform was not impacted in any way as TIO and PayPal's platforms are on separate networks. On December 4, 2017, PayPal's share price dropped $4.33. Plaintiffs alleged that Defendants had knowledge of the breach and exposure of customer information when issuing the November Press Releases whereby they disclosed the existence of "only a security vulnerability." In their allegation, Plaintiffs relied upon the testimony of three former TIO employees. The former employees' testified that in an early November meeting, there was an internal announcement that TIO had been breached around the time that Defendants simply announced that they had discovered a vulnerability.

The District Court found that no allegation of motivation to mislead existed upon the issuing of the press releases. The court found that there was no showing of any stock sold by Defendants during the Class Period or any indication that Defendants stood to gain from the omissions and misstatements. The Court acknowledged the lack of an explanation as to what benefit Defendants could gain by delaying the disclosure of the breach and its implications. Further, the Court found that the testimony of the former employees failed to show that Defendants had knowledge of the breach affecting 1.6 million customers and that Defendants used that knowledge to deceive the market. Therefore, in the absence of a showing that the press releases were made with a guilty state of mind, Plaintiffs' allegations failed to show the existence of scienter.

Sgarlata v. PayPal Holdings, Inc., 2019 WL 4479562 (N.D. Cal. Sept. 18, 2019).