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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (October 1, 2019–December 31, 2019)

By Kenneth M. Silverman and Brian Katz[*]

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 October 1, 2019 through December 31, 2019.

The SEC finalized two new rules for implementation, and proposed ten new rules this quarter. While the two final rules relate to technical matters, there have been significant proposals that will affect practitioners across the securities industry. The focus of the SEC's rulemaking this quarter seems to be on modernization of its regulatory framework in order to reduce unnecessary restrictions on capital formation and harmonize existing rules for improved simplicity. The key changes are summarized below. Further, in December 2019, the SEC released its semi-annual regulatory docket outlining its current rulemaking initiatives. The list contains 17 items targeted for completion in the next 12 months, up from three items on last spring's regulatory docket.

Proposed Rules

Amendments to the definitions of "Accredited Investor" and "Qualified Institutional Buyer"

The SEC has proposed amendments to the definitions of both "accredited investors" and "qualified institutional buyers" in the 1933 Act in furtherance of its efforts to streamline the various private offering exemptions. The proposed amendments to Regulation D and Rule 144A respectively represent the SEC's first proposal in connection with its June 18, 2019 concept release that promised a wholesale review of the exempt offering framework.

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The SEC proposes to expand the definition of "accredited investor" in several ways. With respect to natural persons who do not otherwise satisfy the financial thresholds for "accredited investor" status, the proposed rule would allow investors with certain professional certifications that evidence knowledge of the securities industry to qualify. These qualifications would be selected and published by the SEC at a later date, though they listed a few certifications (e.g., a Series 7 license) that they expect to include. In addition, the definition would be expanded to permit "knowledgeable employees" of private funds to invest in funds set up by their employers. In its concept release, the SEC acknowledged that the financial threshold is not a perfect proxy for the ability to make an informed investment decision. Many commenters agreed that adding some sophistication-based eligibility would be appropriate and beneficial. In each case, the persons covered by the expanded definition would be expected to have the relevant experience and expertise to ask informed questions or access information that would allow them to make an investment decision. The proposal also provides for further expansion of the definition to include certain types of entities and firms (including registered investment advisors, rural business investment companies, limited liability companies and certain other entities meeting an investments-owned test) that the SEC has deemed meet the relevant standard to participate in exempt offerings.

Lastly, the SEC proposes to expand the definition of "qualified institutional buyers"—entities with a large institutional presence (including a minimum of $100 million in assets) permitted to purchase certain restricted securities in resales under Rule 144A—to allow the new entities permitted to qualify as accredited investors to qualify also as "qualified institutional buyers." This conforming change will maintain consistent treatment across the exempt offering framework and would encompass all of the entities suggested for inclusion by commenters responding to the aforementioned concept release.

Due to the challenges associated with the COVID-19 pandemic, the SEC announced that it will not take final action before April 24, 2020 in order to allow commenters additional time if needed.

Auditor Independence Amendments

Recently, the SEC has taken steps to reduce the conflict restrictions on audit firms, as when they amended the Loan Provision under Rule 2-01 of Regulation S-X in the second quarter of 2019. In the same vein, the SEC proposes to update Rule 2-01 by amending the definition of "affiliates of the audit client." Audit firms are restricted from doing business with affiliates of an audit client in order to maintain their independence and assure public

investors that their services are free of bias or conflict and that their findings are therefore reliable. However, the SEC recognizes that this rule results in many situations where the prohibited engagement with an affiliate would not pose a threat to the auditor's objectivity and impartiality. Currently, any entity "under common control with the audit client" (a "sister entity") is deemed to be an affiliate of the audit client. The frequent acquisition and disposition of portfolio companies in the private equity and investment funds context renders the current affiliate definition particularly burdensome for such industries, all while offering little probative value as to potential conflicts. In addition to the onerous compliance obligations, the SEC is concerned that as currently drafted, the rules have a negative impact on the competitiveness of the market for audit and non-audit services when the number of audit firms a company may be permitted to hire is severely limited by the auditor independence rules.

To address these concerns, the SEC proposes to add materiality qualifiers to the "common control" portion of the affiliate definition to narrow the application of independence restrictions to sister entities that are material to their controlling entity. For example, if Portfolio Company A is under common control with Portfolio Company B and engages Firm X for its audit, so long as Portfolio Company B is not material to the controlling entity, Portfolio Company B would likely be permitted to engage Firm X as its auditor absent some other relationship that would conflict with Rule 2-01(b). The SEC believes that investors will welcome this increased flexibility, and that the rule will be administrable as existing requirements call for auditors to make similar materiality assessments, but has asked for comment on whether audit firms would have difficulty applying this new materiality standard in their compliance analysis. The proposal includes conforming changes to the application of the investment company complex definition in Rule 2-01(f)(14) so that the materiality qualifier for operating companies described above will also be applied in the investment funds and investment advisory context.

The proposal also includes a reduction of the look-back period applicable to the independence of an auditor of a first-time SEC filer to one year for domestic first-time filers. Currently, domestic first-time filers are required to engage an auditor that was independent of them for all prior periods covered by the registration statement they file. This can result in a look-back of up to three years, while for foreign private issuers, the look-back is only one year. The SEC proposes to harmonize the treatment, and apply the one year look-back to all first-time filers in order to put domestic issuers on the same footing as foreign private issuers.

Lastly, the SEC proposes slight reductions on the independence

requirements applicable to partners at audit firms and any other "covered person." Currently, Rule 2-01(c)(3) "prohibits, at any point during the audit and professional engagement period, the accounting firm or any covered person from having 'any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders.' " Cognizant that the prohibitions on business relationships are overinclusive, the SEC proposes removing the reference to substantial stockholders and using a significant influence analysis that looks at "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client." Covered persons will also benefit from certain additional exclusions to the list of independence-impairing relationship to allow certain student loans and *de minimis* consumer loans to be outstanding.

Due to the challenges associated with the COVID-19 pandemic, the SEC announced that it will not take final action before April 24, 2020 in order to allow commenters additional time if needed.

Proxy Rules Amendment

Proposed changes to the proxy voting rules promise increased control for corporate managers and greater challenges for shareholders who wish to affect governance. Under the new proposed rules, in order to continue to rely on the exemptions in Rules 14a-2(b)(1) and 14a-2(b)(3) under the 1934 Act (offering an exemption from the Schedule 14A filing requirement for proxy solicitations), proxy voting advisory firms like ISS and Glass Lewis will be required to specifically disclose their material conflicts of interest, in a manner stipulated by the SEC. The SEC raised concerns that under the current regime, proxy advisory conflicts are inadequately disclosed. The proposing release calls for firms to detail the nature of any such conflicts rather than issue mere boilerplate disclosure and sets out certain enhanced disclosure standards that proxy advisory firms must meet.

Responding to calls from the corporate executives for more opportunities to contest the recommendations of proxy advisory firms, the SEC has proposed an overhaul that would require proxy advisory firms to present their recommendations privately to a registrant's management prior to disseminating them in order to provide management an opportunity to correct inaccuracies, misleading statements or faulty methodologies. The SEC argues in its proposal that under the current rules, registrants lack an opportunity to engage with proxy advisory firms in their research process or to contest their findings after they issue a

recommendation. New proposed Rule 14a-2(b)(9)(ii) would require a proxy advisor firm to allow a registrant that has filed its proxy at least 25 days prior to its meeting at least three business days to review its recommendation and related findings. Registrants may receive additional review time if they file their proxies earlier than 45 days prior to the applicable shareholder meeting. Proxy advisory firms would also be required to provide registrants a final notice of their recommendation after the initial review period to allow registrants to assess any revisions made as a result of their initial review. Registrants would have two business days to review the final notice and determine whether to provide a response and request a hyperlink to the registrant response be included in the voting advice delivered by the proxy advisory firm to its clients. Soliciting persons other than the registrant who intend to deliver their own proxy statements and proxy cards to shareholders contesting the registrant's solicitation (e.g., an activist shareholder) would also be afforded the same review right as a registrant. Proxy advisory firms would not be obligated to accept any comments they receive. However, they would be subject to Rule 14a-9 liability prohibiting materially misleading misstatements or omissions in their advisory material. Rather than simply being subject to fiduciary obligations to their clients, under the rule as proposed, proxy advisory firms would have to contend with the 1934 Act's anti-fraud rules.

These proposals promise to be contentious and will be fiercely opposed by proxy advisory firms. ISS for instance has already initiated suit against the SEC on related interpretative guidance issued by the SEC on August 21, 2019. Some commentators have raised concerns that management will have ample incentive to challenge proxy advisory firms and intimidate them into supporting existing management and their policies, thereby interfering with good corporate governance overseen by shareholders.[1] The SEC has certainly stimulated a lively public debate with their proposal. Comments are due by February 3, 2020.

District Court of New Jersey Dismisses First Amended Class Action Complaint, Finding Allegations of Wrongdoing Untethered to Material Misstatements or Omissions

On November 12, 2019, the United States District Court for New Jersey dismissed plaintiffs' First Amended Complaint in an action brought against Galena Biopharma, Inc. ("Galena"), and several of its officers and employees (collectively, "Defendants"), by Galena investors ("Plaintiffs"), holding that Defendants' alleged wrongdoings were not linked to any alleged material misstatement or omission and thus did not establish fraud under Section 10(b) and 20(a) of the Sec. Exchange Act of 1934.

On February 13, 2017, Plaintiffs filed a Putative Securities Class Action Complaint on behalf of persons and entities that purchased Galena stock from August 11, 2014, through January 31, 2017 (the "Class Period"). Plaintiffs alleged that Defendants made several materially false or misleading statements throughout the Class Period. In an August 11, 2014, form 10-Q filing, an earnings call and a press release, Defendants made several statements concerning its fentanyl-based drug Abstral. Plaintiffs claimed that statements concerning Abstral's net sales and revenues failed to disclose that the results were achieved through illegitimate schemes and that 30% of Abstral's sales came from two doctors who sought to manipulate the company's stock. Both doctors' clinics were eventually seized after they were convicted of numerous criminal offenses. Plaintiffs further allege that in an August 6, 2015, form 10-Q and after the clinics were shut down, Galena stated that Abstral's "underling metrics were all trending upwards," and that its Abstral business was "growing." The form 10-Q further stated, however, that any "significant change" to Galena's commercial strategy could materially affect future earnings. As a result of the clinics being shut down, Galena's Abstral revenues dropped significantly and Galena's stock price decreased by 7.4% to $1.63 on August 6, 2015. Further, in a series of public statements, including a March 10, 2016, form 10-K, Galena disclosed that it had been subpoenaed in connection with the investigation of the doctors and that it could face penalties as a result. Ultimately, Galena's stock price fell to $1.28 on February 1, 2017.

The District Court found that while Plaintiffs provided allegations that could potentially support a 10(b) claim, the First Amended Complaint failed to distinguish the allegations as an independent basis for a 10(b) violation. Instead, the Court characterized the allegations as a "shotgun" approach and a futile attempt to argue that all allegations establish a viable 10(b) claim. The Court found that there was no showing that Defendants knowingly or recklessly misled investors. Instead, the Court stated "the law required Galena to disclose the investigation and its potential legal ramifications, which Galena appears to have done."

In re Galena Biopharma, Inc. Sec. Litig., Fed. Sec. L. Rep. (CCH) P 100605, 2019 WL 5957859 (D.N.J. 2019).

District of Nevada Refuses to Dismiss a Securities Class Action Based on Conflicting Materiality of "Patent-Pending" Language

On December 10, 2019, the United States District Court for the District of Nevada denied a motion to dismiss in a securities

class action against CV Sciences, Inc., ("CV Sciences") a life-science company specializing in Cannabidiols ("CBD"). Plaintiffs alleged CV Sciences violated Section 10(b) of the Securities Exchange Act of 1934 by using the phrases "patent-pending," "patent-protectable," and "proprietary" to describe its product even after the United States Patent and Trade Office (USPTO) had twice rejected the patent, including a final rejection. The product was a chewing gum that combined CBD and nicotine to treat smokeless tobacco use and addiction. The product was rejected for being obvious.

On August 24, 2018, Plaintiffs filed a Class Action Complaint on behalf of all investors who purchased or acquired CV Sciences common stock between June 19, 2017 and August 20, 2018. CV Sciences filed a patent application with the USPTO on May 16, 2016. The USPTO made a non-final rejection on April 27, 2017, and a final rejection on December 14, 2017. Plaintiffs alleged CV Sciences never disclosed this material information to the public. Instead, starting on June 19, 2017 and continuing through August 1, 2018, CV Sciences and its executive officers made several statements in press releases, Corporate Updates to investors, Form 10-Q's, and Form 10-K that used the phrases "patent-pending," "patent-protectable," and "proprietary," without stating the rejected status of the patent. For example, following the final rejection, CV Sciences filed its 2017 Form 10-K and stated, "[the patent] is based on proprietary formulations, processes and technology that we believe are patent-protectable. In May 2016, we filed a patent application for these formulations and processes with the U.S. Patent and Trademark Office." On August 20, 2018, Citron Research, a non-party, disclosed on Twitter the rejected status and CV Sciences failure to publicly disclose the status. Following that publication, CV Sciences stock dropped from $9.20 to $3.40, more than 63%. In its motion to dismiss, CV Sciences argued using those phrases was neither false nor misleading because a patent receiving a final rejection from the USPTO may appeal to the Patent Trial and Appeal Board (PTAB), and therefore the patent process was not yet complete. CV Sciences supported this with reference to a law review article published in 2010 that concluded "more than half" of final rejection patents ultimately receive a patent. In response, Plaintiffs put forth evidence that the percentage of final rejections that are overturned by the PTAB decreased from 41.4% in 2005 to 28.3% in 2018.

The District Court found, "the issue boils down to whether a reasonable investor would believe that a patent remains pending after a final rejection but before potential appeals have been exhausted," and that based on conflicting evidence regarding overturned rejections, the truth of the phrases could not be determined as a matter of law.

In re CV Sciences, Inc. Sec. Litig., 2019 WL 6718086 (D. Nev. 2019).

NOTES:

[1] *See e.g.* Matt Levine, "Advice is Different from Solicitation," Bloomberg, November 6, 2019.