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Four Ways to Improve SEC Enforcement

By Andrew N. Vollmer

False Statements of Belief as Securities Fraud

By Wendy Gerwick Couture

Challenging the Power of SEC ALJs: A Constitutional Crisis or a More Nuanced Approach?

*By Michael A. Sabino and
Anthony Michael Sabino*

Some Comments on the SEC's FCPA Enforcement Proceeding Against BNY Mellon

By Robert A. Barron

Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

By Victor M. Rosenzweig



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Quarterly Survey of Sec Rulemaking and Major Appellate Decisions (July 2, 2015 — September 30, 2015)

By Victor M. Rosenzweig*

This issue's Survey focuses on the 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 2, 2015 through September 30, 2015.

SEC Adopts Final Rule on Pay Ratio Disclosure

On August 5, 2015, the SEC adopted a final Rule that requires public companies to disclose the ratio of compensation of its CEO to the median compensation of its employees. (See **Release Nos. 33-9877; 34-75610**). The SEC has adopted the Rule under Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank"), and as such has amended Item 402 of Regulation S-K ("Item 402") to require the pay ratio disclosure in annual reports, proxy or information statements, or registration statements that require executive compensation disclosure under Item 402. However, the pay ratio disclosure does not apply to emerging growth companies, smaller reporting companies or foreign private issuers. The pay ratio may not be disclosed as a percentage.

Specifically, new paragraph (u) will be added to Item 402 as the final Rule, and pay ratio disclosure will be considered "filed" and thus subject to potential liability under the 1933 and 1934 Acts, including 1934 Act Section 18 liability. Under the final Rule, the definition of employees includes both U.S. and non-U.S. employees (subject to certain exceptions) for the company and all consolidated subsidiaries. In addition, the definition is not limited to salaried employees, and includes part-time, seasonal and temporary employees. However, the final Rules exclude workers whose compensation is paid by an unaffiliated third party but work as independent contractors for the company. In addition, there is a *de minimis* exemption to the definition of employee

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that allows companies, subject to certain limitations, to exempt non-U.S. employees when those employees account for five percent or less of the companies' combined total U.S. and non-U.S. employees.

With respect to the Principal Executive Officer (PEO), in circumstances whereby the PEO is replaced by another PEO during the fiscal year, a company will have two options. It may either (i) combine the total compensation calculated pursuant to the summary compensation table in Item 402 by including all persons who received PEO compensation or (ii) annualize the existing PEO's compensation. Annualizing compensation is also permitted for permanent employees who worked for part of the companies' fiscal year. It is not permitted for seasonal or temporary employees.

The pay ratio disclosure is calculated by identifying the median employee once every three years. As such, once a company has identified its median employee, it may rely on that median employee for the other two years, so long as there has been no change in employee population or employee compensation arrangements that the company reasonably believes would result in a significant change in the pay ratio disclosure. In addition, when determining the number of employees to use in identifying the median employee, the company is permitted to use any date within the final three months before the last day of the company's completed fiscal year.

Notably, the pay ratio disclosure does not specify any required methodology to identify the median employee. For example, the company may identify the median employee by using annual total compensation, or any other compensation measure consistently applied to all employees included in the calculation. In addition, a company is allowed to use its employee population, statistical sampling or other "reasonable methods" in determining the pool of employees from which the median is found.

Although the final Rule gives companies flexibility in allowing companies to identify its median employee, the company must disclose the methodology, assumptions and estimates that it uses to ascertain such median employee. For instance, if statistical sampling is used to determine the pool of employees, then the company must disclose the size of the sample and the estimated whole population, along with any material assumptions used for the sampling method used.

The final Rule states that the companies' first reporting period will be its full fiscal year beginning on or after January 1, 2017. A transition period is allowed for new registrants, as the first pay ratio disclosure is not required until the first fiscal year beginning after (i) a period of twelve calendar months beginning on or

after January 1, 2017 and (ii) the registrant has filed at least one annual report that does not contain the pay ratio disclosure.

SEC Adopts Amendments to Investment Company Act Removing Certain References to Credit Ratings in Rule Governing Money Market Funds

On September 16, 2015, in order to implement portions of the Dodd Frank Act, the SEC adopted amendments removing credit rating references in Rule 2a-7 of the Investment Company Act of 1940 (the “ICA”), the primary Rule that governs money market funds (**See Release No. IC-31828**). In addition, the SEC also amended Rule 2a-7’s provisions concerning issuer diversification by removing the exclusion for securities subject to a guarantee issued by a non-controlled person.

Prior to the amendment, Rule 2a-7 used credit rating references (i.e. NRSRO ratings) to determine what constituted minimal credit risk “eligible securities”. Under the amendment, the SEC will replace the reporting of credit rating references with a standard referred to as the single uniform minimal credit risk finding. This finding is determined based on an inquiry into the capacity of the issuer’s or guarantor’s (of a security) ability to meet its financial obligations. In addition to the aforementioned standard, the SEC has codified general credit analysis factors from the proposing release to help promote uniform credit quality standards.

Compliance under the Rule begins October 14, 2016. The Rule becomes effective 30 days after the date of publication in the Federal Register.

SEC Adopts New Rules Concerning the Registration Process for Security-Based Swap Dealers

On August 5, 2015, the SEC adopted new Rules for the process of registration of security-based swap (“SBS”) entities (**See Release No. 34-75611**). This Rule implements the mandate of the Dodd Frank Act for the registration and regulation of SBS entities. The SEC has adopted these new Rules through Rules 15Fb1-1 through 15Fb6-2, and related Forms SBSE, SBSE-A (for entities registered or registering with the CFTC as swap dealers or major swap participants) and SBSE-BD (for broker dealers) under Section 15F of the 1934 Act.

Rule 15Fb2-1 concerns the registration process for an SBS entity. It is this Rule that directs the SBS entity to the correct form to file, how the application must be filed and the manner in which the SEC will determine whether to grant registration. In addition, the SBS entity must file two separate certifications, one

of which includes a senior officer's certification that after due inquiry, she has reasonably determined that the SBS entity has developed and implemented policies and procedures reasonably designed to prevent violations of federal securities laws. The other certification under Rule 15Fb6-2 requires the chief compliance officer (CCO) to certify that the SBS entity does not have knowledge of a statutorily disqualified person who effects security-based swaps on the SBS entities' behalf.

For non-resident SBS entities, Rule 15fb2-4 requires that the SBS entity obtain a U.S. agent for service of process, along with an opinion of counsel stating that the SBS entity can provide the SEC with access to books and records, and allow for onsite examination. SBS entities must comply with the new Rules beginning on the later of six months after the date of publication in the Federal Register of certain final Rules.

SEC Proposes Rule of Practice 194 on Process for Applications by Security-Based Swap Dealer Associated Persons Involved in Security-Based Swaps

On August 5, 2015, in conjunction with the adoption of new Rules governing SBS entities, the SEC proposed Rule of Practice 194 concerning the application to the SEC for an order allowing an associated person of an SBS entity subject to statutory disqualification to participate in effecting security-based swaps on behalf of the SBS entity. (**See Release No. 34-75612**). In order for the SEC to issue an order granting relief, the SBS entity would need to show that it is in the public interest to permit the associated person of the SBS entity to effect security-based swaps on behalf of the SBS entity. In order to meet the public interest standard, an SBS entity must show that the terms or conditions of association, procedures or proposed supervision is capable of mitigating the risk of the associated person engaging in activity that could potentially harm the market.

Comments to the proposed Rule may be received for a period of 60 days after publication in the Federal Register.

SEC Proposes Rules to Promote Effective Liquidity Risk Management for Open-End Funds

On September 22, 2015 the SEC proposed new Rule 22e-4, under the ICA seeking to promote effective liquidity risk management for the Open-End Fund Industry, which includes mutual funds and exchange-traded funds (ETFs) (**See Release No. 33-9922**). The proposed Rule seeks to enhance disclosure concerning fund liquidity and redemption practices, in part, by requiring

each registered open-end fund to create a liquidity risk management program. This Rule, as currently proposed, would not apply to money market funds.

Liquidity risk “means the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund’s net asset value”. Open-end funds may face liquidity risk when a certain amount of investors redeem their shares in a compressed period of time. Accordingly, funds should consider cash flows into specific investment strategies when assessing whether the fund has an adequate level of liquidity.

The liquidity risk management program (the “Program”) requires open-end funds to: (i) classify the liquidity of fund portfolio assets providing for several liquidity buckets, (ii) make periodic assessments of the fund’s liquidity risk, (iii) establish a three-day liquid asset minimum and (iv) obtain Board approval and review of the Program, as well as any material changes, and appoint fund officers as administrators for the Program. By requiring these actions, the Program can help open-end funds monitor and maintain liquid assets to provide for shareholder redemptions. In addition to the aforementioned requirements, proposed Rule 22e-4 would also codify SEC guidelines on a 15% limit on “illiquid” assets, thereby restricting open-end funds from holding more than 15% of total assets in “illiquid” assets. “Illiquid” assets are assets that cannot be sold or disposed of in the ordinary course of business within seven days without incurring a significant discount from the fund’s original valuation.

In addition to new Rule 22e-4, the SEC is proposing to amend Rule 22c-1 to allow funds, under certain conditions, to use “swing pricing”, whereby the fund adjusts the NAV of the fund’s shares in order to pass the cost of shareholder redemption on to shareholders who redeem.

With respect to disclosure, the SEC proposed amendments to Form N-1A, which would require funds to disclose: (i) the amount of time between a shareholder’s request for redemption and the fund’s payment of those redemption proceeds and (ii) the manner by which the fund chooses to complete shareholder redemption requests. If swing pricing is used, the fund would have to explain how swing pricing is used and the effect of swing pricing. Proposed amendments to proposed Form N-PORT would, among other requirements, require funds to report the liquidity classification of each fund’s assets based on the classification required by the liquidity risk management program. Proposed amendments to proposed Form N-CEN would, among other requirements, require the fund to disclose whether it engaged in swing pricing during the reporting period.

Comments to the proposed Rule may be received for a period of 90 days after publication in the Federal Register.

Appellate and Other Decisions of Note

D.C. Circuit Rejects Challenge to SEC Political Money Rule as Untimely

On August 25, 2015, the United States Court of Appeals for the District of Columbia Circuit dismissed a challenge to a “four-year-old rule, promulgated under the Investment Advisers Act of 1940 (the “Investment Advisers Act”), regulating campaign contributions by investment advisers” as time-barred because, under the Investment Advisers Act, any challenge must be brought in the Court of Appeals in the first instance, “within sixty days of promulgation of the rule . . .”

In 2010, the SEC promulgated a rule under the Investment Advisers Act that “limit[ed] investment advisers’ campaign contributions to certain government officials.” 17 C.F.R. § 275.206(4 to 5). Specifically, under the rule, “[i]f an investment adviser or certain of its employees contributes to the political campaign of a government official with the power to influence the adviser’s hiring by a government client, the adviser must wait two years before it may provide services for compensation to that government client.”

In August 2014, the plaintiffs sued the SEC “in federal district court seeking an order declaring that the rule, as applied to federal campaign contributions, exceeds the [SEC’s] statutory authority, violates the Administrative Procedure Act, and violates the First Amendment.” The United States District Court for the District of Columbia dismissed the suit for lack of subject matter jurisdiction. The D.C. Circuit affirmed, holding “that the word ‘order’ in the Investment Advisers Act recognizes the exclusive jurisdiction of the Court of Appeals to hear challenges to rules promulgated thereunder” and that there was no excuse for plaintiffs’ delay in filing the challenge more than sixty days after the promulgation of the rule, as required by 15 U.S.C.A. § 80b-13(a).

New York Republican State Committee v. S.E.C., Fed. Sec. L. Rep. (CCH) P 98612, 2015 WL 5010051 (D.C. Cir. 2015).

D.C. Circuit Confirms on Panel Rehearing that Conflict Minerals Rule Violates the First Amendment

On August 18, 2015, the United States Court of Appeals for the District of Columbia Circuit held, on a panel rehearing, that the Conflict Mineral Rule requiring issuers using conflict minerals to

state on their websites that their products were not “DRC conflict free” violated the First Amendment.

Under Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. No. 111-203, 124 Stat. 1376, the SEC must issue regulations requiring firms using “conflict minerals” to investigate and disclose the origin of those minerals. For the purpose of this statute, conflict minerals are gold, tantalum, tin, and tungsten that originated from the Democratic Republic of the Congo during the Congo war. One of the rules adopted by the SEC, requires, if applicable, that an issuer describe its products as not “DRC conflict free” both in the report it files with the Commission and on its website. 15 U.S.C.A. § 78m(p)(1)(A)(ii).

On April 14, 2014, the D.C. Circuit first held that the SEC rule requiring sellers of conflict minerals obtained from the Democratic Republic of the Congo to state on their websites that their products were not conflict free violated the sellers’ First Amendment rights. *National Ass’n of Mfrs. v. S.E.C.*, 748 F.3d 359, 371, Fed. Sec. L. Rep. (CCH) P 97924 (D.C. Cir. 2014) (overruled by, *American Meat Institute v. U.S. Dept. of Agriculture*, 760 F.3d 18, 36 Int’l Trade Rep. (BNA) 483 (D.C. Cir. 2014)) and adhered to on reh’g, Fed. Sec. L. Rep. (CCH) P 98600, 2015 WL 5089667 (D.C. Cir. 2015) (“By compelling an issuer to confess blood on its hands, the statute interferes with that exercise of the freedom of speech under the First Amendment.”). On November 18, 2014, the D.C. Circuit granted these petitions and ordered the parties to submit supplemental briefs addressing three issues: (1) the effect of a recent decision, *American Meat Institute v. U.S. Dept. of Agriculture*, 760 F.3d 18, 36 Int’l Trade Rep. (BNA) 483 (D.C. Cir. 2014) (en banc), “on the First Amendment issue in this case regarding the conflict mineral disclosure requirement;” (2) the meaning of “purely factual and uncontroversial information” as used in *American Meat*; and (3) whether the “determination of what is ‘uncontroversial information’ [is] a question of fact.”

On panel rehearing, the D.C. Circuit first held that even under the *American Meat Institute* decision, the more rigorous standard of review applied. The Court then stated that even under the looser standard of review, the Conflict Mineral Rule still violated the First Amendment because it requires unconstitutional compelled commercial disclosures.

National Ass’n of Manufacturers v. S.E.C., Fed. Sec. L. Rep. (CCH) P 98600, 2015 WL 5089667 (D.C. Cir. 2015).

Ninth Circuit Issues Insider Trading Decision Consistent with the Second Circuit’s Decision in *United States v. Newman*

On July 6, 2015, the United States Court of Appeals for the

Ninth Circuit affirmed the conviction of a remote tippee for insider trading, holding that the evidence supported a finding that the tipper received a meaningful personal benefit from the tippee due to the familial relationship, and that the defendant-remote tippee knew of that relationship.

The defendant tippee received information indirectly from his brother-in-law who worked in “Citigroup’s healthcare investment banking group.” “Rather than trade through his own brokerage account . . . [the defendant] arranged to deposit money, via a series of transfers through other accounts, into a brokerage account held jointly in the name of his wife’s sister and her husband, Karim Bayyouk. [The defendant] then shared the inside information with Bayyouk and the two split the profits . . .” At trial, “the Government presented evidence that [the defendant] knew full well that [his brother in law who worked at Citigroup] was the source of the information” and that the family “enjoyed a close and mutually beneficial relationship.” The defendant was convicted of insider trading and conspiracy to commit insider trading.

The main issue on appeal was the effect of the Second Circuit’s decision in *U.S. v. Newman*, 773 F.3d 438, Fed. Sec. L. Rep. (CCH) P 98592 (2d Cir. 2014), *cert. denied*, 2015 WL 4575840 (U.S. 2015). As we previously reported in 41 Q. SURV. SEC RULEMAKING 120 (2015), the Second Circuit in *Newman* held that for a tippee to be convicted of insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that the confidential information was disclosed by an insider *and* that the insider received a personal benefit from disclosing it. The Ninth Circuit stated that while “*Newman* is not binding on us . . . we would not lightly ignore the most recent ruling of our sister circuit in an area of law that it has frequently encountered.” Accordingly, the Ninth Circuit upheld the conviction “find[ing] that the evidence was more than sufficient for a rational jury to find both that the inside information was disclosed in breach of a fiduciary duty, and that [the defendant] knew of that breach at the time he traded on it.” Moreover, the Court held that evidence establishing that the tipper received a personal benefit because “the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading.”

U.S. v. Salman, 792 F.3d 1087, Fed. Sec. L. Rep. (CCH) P 98567 (9th Cir. 2015), for additional opinion, see, 2015 WL 4071557 (9th Cir. 2015).

Status of Challenges to Constitutionality of SEC Administrative Proceedings; SEC's Proposed Modernization of Such Proceedings

On September 24, 2015, the SEC announced that it “voted to propose amendments to rules governing its administrative proceedings.” Specifically, “[t]he proposals include three primary changes to the Commission’s Rules of Practice that: Adjust the timing of administrative proceedings, including by extending the time before a hearing occurs in appropriate cases; Permit parties to take depositions of witnesses as part of discovery; [and] Require parties in administrative proceedings to submit filings and serve each other electronically, and to redact certain sensitive personal information from those filings.” SEC Chair, Mary Jo White, further stated that: “The proposed amendments seek to modernize our rules of practice for administrative proceedings, including provisions for additional time and prescribed discovery for the parties.” SEC Press Release 2015-209, *available at* <http://www.sec.gov/news/pressrelease/2015-209.html>.

The SEC’s proposed changes come in the wake of several decisions staying SEC administrative proceedings pending a determination of whether the use of the administrative courts, specifically the appointment of the agency’s administrative law judges, is constitutional. *See, e.g., Tilton v. S.E.C.*, No. 15-2103 (2d Cir. Sept. 17, 2015) (staying SEC in-house action pending a determination as to constitutionality of administrative proceedings); *Duka v. U.S. S.E.C.*, Fed. Sec. L. Rep. (CCH) P 98597, 2015 WL 4940083 (S.D. N.Y. 2015) (same), *appeal filed*, No. 15-2732 (2d Cir. Aug. 27, 2015); *Hill v. S.E.C.*, Fed. Sec. L. Rep. (CCH) P 98359, 2015 WL 4307088 (N.D. Ga. 2015).

On the other hand, some courts have held that district courts lack jurisdiction to hear challenges to the SEC’s use of in-house courts. For example, in *Bebo v. S.E.C.*, the Seventh Circuit held that the district court lacked jurisdiction to hear such a challenge because it saw no evidence “that Congress intended for plaintiffs . . . who are already subject to ongoing administrative enforcement proceedings to be able to stop those proceedings by challenging the constitutionality of the enabling legislation or the structural authority of the SEC . . . [and i]f the SEC renders an adverse final decision, judicial review awaits in the court of appeals.” No. 15-1511 (7th Cir. Aug. 24, 2015). On September 29, 2015, the D.C. Circuit agreed, and held that district courts lack subject matter jurisdiction over challenges to the constitutionality of administrative proceedings because the plaintiff “can secure judicial review in a court of appeals when (and if) the proceeding culminates in a resolution against him.” *Jarkesy v. S.E.C.*, 2015 WL 5692065 (D.C. Cir. 2015).