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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions (April 1, 2020—June 30, 2020)

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 April 1, 2020 through June 30, 2020.

The SEC finalized five new rules for implementation, and proposed one new rule this quarter. Rulemaking has not been a priority for the SEC this quarter as SEC staff have devoted substantial time and resources to formulating temporary relief measures and associated guidance in response to the challenges created by the COVID-19 pandemic and the corresponding preventive measures taken in response.

The rules finalized in this quarter show that the SEC has not acted on any proposals with comment periods expiring in March 2020, which is consistent with what the SEC indicated earlier this year in the wake of the COVID-19 crisis. Though the SEC did not formally extend comment periods, it is likely that comments received after the deadline had passed would still be considered by the staff.

Final Rules

Modifications to the Volcker Rule Covered Fund Provision

On June 25, 2020, in conjunction with the Federal Reserve, OCC, FDIC and CFTC, the SEC released a final rule adopting amendments to the regulations implementing Section 13 of the Bank Holding Company Act pursuant to Section 619 of the Dodd-Frank Act. Section 619 and the regulations promulgated thereunder (often referred to collectively as the "Volcker Rule") generally

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bar banking entities from engaging in proprietary trading or holding interests in hedge funds and private equity funds ("covered funds"), subject to certain exemptions.

The exemptions available from the covered fund rules are intended to account for situations where the spirit of the Volcker Rule and its aim of protecting bank customers from the risks of speculative investments is not threatened. In the proposed rule issued in February 2020, the agencies jointly proposed several new exemptions to the covered fund rules. While many of the more technical regulations under the Volcker Rule are relevant mainly to a bank regulatory practice, the covered fund exemptions for credit funds, venture capital funds and wealth management or customer-driven funds should be of interest to lawyers with practices interfacing institutional investors, venture capital investing or wealthy management.

The credit fund exemption from the covered fund rules would allow banks to invest in issuers whose assets consist of loans, debt instruments and related rights and assets, as well as interest rate and foreign exchange derivatives, and equity securities or rights received on customary terms in connection with the fund's debt or when received in relation to disposing, holding or servicing such debt. Any investment in such a credit fund would be subject to certain requirements in order to qualify. For example, a qualifying credit fund may not engage in proprietary trading, and a bank investing in such a fund would need to meet certain disclosure and soundness standards. The agencies believe that the credit fund exclusion in the final rule satisfies the intent of Congress that while banks should be restricted from participation in hedge funds and private equity funds, they should have flexibility to extend credit using fund structures provided that there are adequate safeguards in place. However, the agencies rejected calls from some commenters to allow credit funds access to a broad range of assets that would include products like credit default swaps that the agencies view as risky and unrelated to the extension of credit.

In an effort to make it easier for banks to extend credit in the venture capital space, the agencies have finalized an exemption from the covered fund rules to allow such capital flow. Qualifying venture capital funds that do not engage in proprietary trading would be able to receive investment from banking sponsors so long as the banking entity making an investment provides certain written disclosures to investors and ensures that the activities of the issuer are consistent with safety and soundness standards substantially similar to those that would apply if the banking entity engaged in the activities directly. The agencies believe that greater involvement in venture capital from banks will "benefit

the broader financial system" and open up "an additional avenue for providing funding to smaller businesses, which can help to support job creation and economic growth."[1]

Lastly, the agencies approved the exclusion of certain wealth management fund structures and customer facilitation vehicles from the covered fund rules in order to allow banks greater flexibility in meeting the needs of their clients. The wealth management exception is designed to allow banks to manage family wealth using a fund structure where the banking entity provides fiduciary or advisory services and takes no more than a de minimis interest in the fund's outstanding ownership interests. In the comment process, the agencies determined to add a requirement that the majority of interests in the wealth management entity are owned by its family customers in order to allay concerns that the exception could be used by hedge funds or private equity funds to evade the intent of the Volcker Rule. The customer facilitation vehicle exception is a customer-directed exemption designed for circumstances where a customer requests exposure to a certain transaction, strategy or service provided by the banking entity. In such cases, a bank may use a fund structure to provide that service to its clients where the client prefers to have such exposure through a fund rather than directly via a bank. Like the wealth management exception, the rule has an ownership requirement: the customer for whom the issuer is created must own all of such issuer's ownership interests, subject to a de minimis exception.

These developments promise to increase flexibility for banks while maintaining the spirit of the Volcker Rule and its statutory framework. The final rule is effective as of October 1, 2020.

United States Court of Appeals for the First Circuit Affirms Lower Court's Dismissal of Shareholder Allegations that Ocular and Key Officers Intentionally Misled Investors

On April 9, 2020, the United States Court of Appeals for the First Circuit affirmed the United States District Court for the District of Massachusetts' dismissal of an Amended Class Action Complaint brought by several shareholders (collectively, "Plaintiffs"), against Ocular Therapeutix ("Ocular") and several of its key officers (collectively, "Defendants"). Plaintiffs alleged that Defendants violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder and violated Section 20(a) of the Securities Exchange Act by intentionally misleading investors in conference calls and filings concerning manufacturing problems that led to the U.S. Food and Drug Administration's (FDA's) refusal to approve its drug product, Dextenza.

On July 7, 2017, Plaintiffs commenced a Putative Class Action lawsuits against Defendants. On May 7, 2018, Plaintiffs filed a Consolidated Amended Class Action Complaint on behalf of all investors who purchased or acquired Ocular stock between March 10, 2016, and July 11, 2017 (the "Class Period"). In July 2016 and July 2017, the FDA refused to approve Ocular's Dextenza as a steroid treatment for eye pain. Before receiving each notice of denial, the FDA informed Defendants of various deficiencies within Ocular's manufacturing facilities. Plaintiffs alleged that statements made by Defendants during the Class Period in public and in SEC filings pertaining to approval of Dextenza were misleading. First, Plaintiffs alleged that Defendants downplayed the negative implications of FDA inspections of its manufacturing facilities. Second, Plaintiffs alleged Defendants failed to disclose what effect the FDA inspection reports could have on Ocular's pending application for Dextenza. Third, Plaintiffs alleged that Defendants mislead investors by claiming that Ocular was following standard manufacturing rules in its annual financial reports. Ocular's stock price experienced a significant drop after investor publications reported the negative FDA findings in July 2017.

The United States Court of Appeals for the First Circuit found that Plaintiffs failed to allege facts giving rise to a strong inference of scienter, as Defendants made disclosures in annual financial statements informing investors that a failure to improve manufacturing facilities might delay or prevent the approval of Dextenza. The Court affirmed the District Court's dismissal of the action and stated the context of the Complaint, read in whole, do not give rise to a strong inference that defendants intentionally or recklessly misled investors.

Mehta v. Ocular Therapeutix, Inc., 955 F.3d 194 (1st Cir. 2020).

United States Court of Appeals for the Second Circuit Affirms Lower Court's Dismissal of Plaintiff's Allegations that Kimberly-Clark and Avanos Medical Intentionally Misled Shareholders

On May 27, 2020, the United States Court of Appeals for the Second Circuit affirmed the United States District Court for the Southern District of New York's denial of a motion to file an amended securities fraud complaint brought by an individual Plaintiff, against Kimberly-Clark Corporation Avanos Medical, Inc., and Halyard Health, Inc. (collectively, "Defendants"). Plaintiff alleged that Defendants violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder and Section 20(a) of the Securities Exchange Act by making misrepresentations to shareholders concerning the quality of its surgical gowns.

On June 28, 2016, Plaintiff filed a Putative Class Action Complaint on behalf of investors who purchased or otherwise acquired Kimberly-Clark and Halyard securities between August 8, 2014, and April 29, 2016 (the "Class Period"). Plaintiff alleged that Defendants intentionally misled investors by exaggerating the protective properties of the surgical gowns that they manufactured. The District Court dismissed the case, as Plaintiff failed to adequately allege scienter against Defendants. Shares of Avanos' predecessor company experienced a significant drop after a news report said the surgical gowns were less protective than advertised.

Subsequently, Plaintiff filed an amended complaint alleging that recent employee testimony given in a California consumer fraud case is a factual basis for the necessary corporate scienter that the District Court held was lacking. Specifically, company employees testified that they notified high-level executives of the gown compliance issues. Thus, Plaintiff alleged that such knowledge was enough to establish adequate corporate scienter.

Nonetheless, the United States Court of Appeals for the Second Circuit denied Plaintiff's motion, holding that Plaintiff did not allege facts sufficient to impute the employees' knowledge to Defendants. Furthermore, the Court stated that because Plaintiff had otherwise failed to plead facts tending to show that senior executives must have known that the challenged statements were false, Plaintiff's proposed amended complaint does not raise a strong inference of collective corporate scienter.

Jackson v. Abernathy, 960 F.3d 94 (2d Cir. N.Y. May 27, 2020).

NOTES:

[1]SEC Release, June 25, 2020: 17 CFR Part 255, Release no. BHCA-9, File no. S7-02-20, p. 88.