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SIGNIFICANT SHAREHOLDER: ALWAYS INFLUENTIAL . . . BUT CANNOT USURP A BOARD'S PROCESS

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A recent U.S. case, *Chester County Employees' Retirement Fund v. KCG Holdings, Inc. et al*,[1] has once again highlighted the importance of boards of directors effectively managing the transaction process involving a company. In this case, the court was critical of a board's actions when a significant shareholder influenced an M&A transaction involving the company.

This decision can be compared to a Canadian decision in *Pente Investment Management Ltd. v. Schneider Corp.*[2] from a number of years ago, where a significant shareholder also had a say in the outcome of a strategic transaction. However, in the Canadian decision, the courts agreed with the actions of the board of directors. Comparing these two cases is instructive of what is required by a board of directors even when there is a significant shareholder involved with the company.

The Facts in *Chester*

Chester is the case of a U.S. company, KCG Holdings, Inc., with a majority shareholder who allegedly wanted to sell its stake in KCG.[3]

Jefferies LLC was KCG's financial advisor and largest shareholder, owning approximately 24% of KCG's outstanding stock. Starting in December 2016, and unknown to KCG, Jefferies began discussions with Virtu Financial, Inc. for the acquisition of KCG by Virtu. In these discussions, Jefferies shared KCG's confidential information and provided a presentation to Virtu, highlighting that a $20 per share acquisition of KCG and a subsequent sale of KCG's bond trading platform, BondPoint, would yield a minimum of $200 million in proceeds and raise KCG's tangible book value by more than $2.20 per share.

While Virtu and Jefferies were engaging in discussions, KCG was developing a restructuring initiative with the assistance of Jefferies. On December 27, 2016, Jefferies had also suggested to David Coleman, KCG's CEO, that a sale of BondPoint would be lucrative for KCG; however, Coleman stated his disinterest in pursuing a sale of BondPoint as it was experiencing significant growth and indicated a preference for the restructuring initiative.

IN THIS ISSUE:

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The plaintiffs, a group of shareholders, alleged that on February 16, 2017, Jefferies and Virtu agreed to a $20 per share acquisition that Jefferies would support. Five days later, Jefferies informed Coleman that Virtu would be making a formal offer to acquire KCG.

On February 23, 2017, Virtu emailed Coleman a non-binding indication of interest to acquire KCG at a price range between $18.50 and $20 per share in cash. Upon receipt of the bid from Virtu, KCG accelerated its efforts to advance the restructuring initiative, believing this would yield more value to shareholders with less risk and disruption. Even though the offer was significantly higher than KCG's then-current trading price of $14.31 per share, it received a "cool" reception from KCG.

On February 26, 2017, KCG's board of directors created a four-person subcommittee of outside directors to recommend independent financial and legal advisors. The subcommittee met with various firms and at their recommendation, the board hired Goldman Sachs as KCG's financial advisor at a board meeting held on March 15, 2017.

At the same meeting, the board discussed the restructuring initiative and Virtu's bid. The board agreed with Coleman and the management team who believed that Virtu's offer undervalued KCG. Coleman and the management team believed that the restructuring initiative would yield 25% more value for KCG compared to Virtu's offer. Goldman reported that "Jefferies (in [its] capacity as shareholder) told both the KCG chairman and CEO that if they didn't engage with Virtu, they would 'no longer be aligned.' "[4] Therefore, despite the board's view that the offer undervalued KCG, the board decided to continue to engage with Virtu based on Jefferies input.

Coleman then sent a letter to Virtu on March 15, 2017, where Coleman conditioned further discussion on whether Virtu would raise the price range and share its retention and compensation plans for KCG's employees. Virtu responded by proposing a non-disclosure agreement, which was executed by Virtu and KCG on March 17, 2017.

Concern regarding Jefferies grew as the firm continued to push to be retained as financial advisor on the potential transaction with Virtu.[5] KCG instructed Virtu not to communicate with Jefferies any further. KCG also requested that Jefferies disclose details of its communications with Virtu, to which Jefferies provided an incomplete list of communications. Despite this, Coleman offered Jefferies a $1 million advisory fee for the restructuring initiative; however, Jefferies was not satisfied and insisted on becoming KCG's acquisition advisor. Coleman then

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recommended that Jefferies serve as co-advisor for the acquisition, but the board subsequently rejected that idea.

After the March 15, 2017 board meeting, news of Virtu's unsolicited offer to purchase KCG was published in various new outlets, leading to an increase in KCG's stock price. Both KCG and Virtu issued press releases confirming the information. Another party contacted Coleman with interest in exploring a strategic combination, however, they soon after advised that they were no longer interested. On March 23, 2017, the board advised Goldman to reach out to other bidders, but Goldman was unsuccessful in finding any serious interest in KCG.

On April 10, 2017, Virtu offered $18.50 per share in cash to acquire KCG. The bid letter included a voting agreement which required Jefferies to support the sale. On April 11, 2017, Jefferies emailed Coleman advising them that they had direct reason to believe that Virtu would amend their offer to $20 per share.

At the April 11, 2017 board meeting, Coleman reported the communication received from Jefferies and advised that the restructuring initiative could return $500 million to KCG shareholders within the next five years. The board then rejected Virtu's $18.50 per share offer and responded with an open-ended price per share above $20.

On April 12, 2017, Virtu delivered its final bid of $20 per share and Jefferies advised the board that this price would be embraced by Jefferies. At the KCG board meeting, all of the directors except Coleman voted in favor of a counter-offer of $20.21, as Coleman believed that the valuation was still too low. However, Coleman stated he would support the offer if closing risks, personnel risks, and the retention pool concerns were eliminated.[6] The next day, the counter-offer of $20.21 was submitted. The counter-offer stated that agreement with Virtu on compensation and a retention pool for KCG's employees was necessary prior to board approval of the acquisition.

The next day, Coleman spoke with KCG's chairman who advised Coleman to resolve any compensation issues prior to negotiating further on share price. Coleman then began negotiations with Virtu and was provided a proposal on the compensation and retention pool. At the suggestion of the chair, Coleman created an exhibit illustrating outstanding compensation issues. This exhibit depicted a $13 million difference in bonus compensation for the top management of KCG (the difference between KCG's $20.21 per share counter-offer and Virtu's $20 per share bid was actually $13.5 million). After receiving the exhibit, Virtu rejected the $20.21 per share counter-offer, however, Coleman and Virtu reached an agreement on the $13 million compensation package and retention pool. At the April 19, 2017 board meeting, the $20 per share price was unanimously approved, subject to a fairness opinion from Goldman.

Coleman and the management team then lowered the company's financial projections in relation to the restructuring initiative, and these revised projections were approved by the board via email. Prior to the revised projections, Virtu's $20 per share bid was at the bottom-end of the discounted cash flow range valuing the company. The revised projections brought the $20 per share bid to the middle of the range, and the revised projections were then used by Goldman to deliver a fairness opinion. The fairness opinion was used by the board to approve the acquisition on April 20, 2017. On July 19, 2017, the acquisition was approved by 75.5% of shareholders and the transaction closed on July 20, 2017.

Post-closing, Jefferies acted as financial advisor to Virtu to sell BondPoint, which resulted in $276 million in after-tax proceeds for Virtu with $7 million to Jefferies.

The Court's Analysis

The court first considered whether the standard of deferential business judgment in *Corwin v. KKR Financial Holdings LLC*[7] was applicable based on the argument that the sale was approved by the majority of shareholders in an informed and uncoerced vote. If shareholders were unable to make an informed decision, the business judgment rule would not apply and the court would use the standard of enhanced scrutiny in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[8]

The court found that misleading information was provided to shareholders, such as insufficient detail with regard to the BondPoint divestiture strategy. KCG's board failed to disclose Coleman's initial view that $20.21 per share was too low and failed to disclose the prior projections. These actions resulted in the court finding that the *Corwin* standard was not applicable in the circumstances, and the court instead applied the *Revlon* standard which provides for enhanced scrutiny. The *Revlon* standard states that directors can use any reasonable route to achieve value maximization and must have a direct role in the sale of a company from start to finish.[9] Using the standard, the court explored the procedural process undertaken by the board in their analysis.

The court was critical of the board's lack of control and management of the process. "Rather than cabining Coleman, or limiting his authority to negotiations over the compensation pool, the full board authorized Coleman to negotiate both the compensation pool *and* the deal price."[10] In fact, the board chairman instructed Coleman to first negotiate the compensation pool and then negotiate the price. The board also approved the more pessimistic projections by management. The court found that "the board placed the interests of members of management, who benefitted from the compensation pool, above the interests of the stockholders" and found that they failed to act in good faith.[11] The board also "fail[ed] to employ a reasonable process that managed Jefferies influence."[12] The board should have taken control of the process regarding both Coleman and the management team, and the influence of Jefferies, their majority shareholder. Due to the procedural faults of the board, the court denied the defendant's motion to dismiss.

The Facts in *Pente Investment Management Ltd.*

Almost 20 years earlier, the decision in *Pente Investment Management Ltd.*[13] demonstrated how a board of directors can keep control of the process even with an opinionated significant shareholder.

The Schneider family owned 17% of the non-voting shares and 75% of the common voting shares of Schneider Corp., which resulted in the Schneider Family having a controlling vote in the future of the company. The Schneider Family was opposed to a sale of Schneider Corp. to Maple Leaf Foods Inc. after Maple Leaf Foods announced an unsolicited take-over bid. Maple Leaf Foods formally made their offer at $19 per share on November 14, 1997, for both the common and Class A non-voting shares of Schneider Corp. The board of directors of Schneider Corp. responded to the bid by establishing a special committee of independent directors to review the offer. The special committee retained a financial advisor and a legal advisor to assist the decision-making process. On November 23, 1997, the board issued a director's circular responding to the offer and recommending that shareholders not tender to the offer as it was not reflective of the fair value of the shares. The board also advised that the Schneider Family had no intention of accepting the offer but "might consider accepting a financially more attractive offer for its [s]hares." On December 11, 1997, Schneider Corp. communicated this to Maple Leaf Foods and requested delivery of an enhanced offer by the next day.

Additional offers were also solicited by the special committee through the financial and legal advisors and through senior management of Schneider Corp. By December 12, 1997, the Schneider board had received three offers. An enhanced offer from Maple Leaf Foods at $22 per share (allowing shareholders to elect to receive part of the offer as shares in Maple Leaf Foods), and offers from Booth Creek Inc. at $24.50 per share (conditional upon 66.66% of common voting shares and non-voting shares being deposited under the offer), and Smithfield Foods worth approximately $23 per share (in the form of a take-over bid for all of the outstanding shares exchangeable into shares of Smithfield).

On December 14, 1997, Schneider Corp.'s management indicated that a strategic merger was in the best interests of the corporation, and the Schneider Family agreed. Prior to the Maple Leaf Foods bid, the Schneider Family had no intention of selling its shares. After receiving the three offers, the Schneider Family indicated tentative preference for the Smithfield offer. The Schneider Family stated that it reviewed the three offers based on "financial value, continuity of Schneider in a manner consistent with the Schneider Family's desires, and the effect of any transaction on customers and suppliers."[14] The Schneider Family stated that the Smithfield proposal met two criteria but did not meet the financial adequacy criteria. The Schneider Family felt that if the financial adequacy criteria could be satisfied, a strategic merger would be in the best interests of Schneider Corp.

The chairman of the Schneider board, together with the financial and legal advisors, created a working group and decided to negotiate with Smithfield and Booth Creek, after which Smithfield increased its offer to $25 per share as a final offer. Booth Creek also submitted a revised offer which was less financially attractive compared to the Smithfield offer.

At the next Schneider board meeting, the Schneider Family stated they wished to accept the Smithfield offer. The financial advisor also advised the Schneider board that the current offer from Smithfield was within the $25 to $29 per share fair price range, but due to the risk associated, the financial advisors stated that the offer should reflect a 6% discount so that its present value was $23.50 per share. However, if the Smithfield offer was permitted to expire and no other change-of-control occurred, the trading range of Schneider Corp. would become $18 to $20 per share.

The special committee recessed and attempted further negotiations with Smithfield that were ultimately unsuccessful. In order for the transaction to occur, the Schneider board had to take a positive step to waive the standstill provision which was included in the confidentiality agreement signed by Smithfield. The Schneider Family asked the Schneider board to do so, and, upon recommendation by the special committee, the Schneider board approved the waiver and the Schneider Family entered into a lock-up agreement with Smithfield.

After hearing about the lock-up agreement with Smithfield, Maple Leaf Foods increased their offer and five Class A shareholders, holding more than 10% of the total Class A shares outstanding, wrote a letter to the Schneider Corp. board complaining that the special committee and the Schneider Family's actions "contaminated the value maximization process" of the company.[15] Maple Leaf Foods thereafter commenced an action stating that the Schneider board's decision was not in the best interest of Schneider Corp. and its shareholders.

The Court's Analysis

The court in *Pente Investment Management Ltd.* commenced a similar analysis to the court in *Chester* by reviewing the actions of the board of directors and the procedural process used. The court began by stating that directors must manage the company according to their best judgment, and that "directors have the absolute power to manage the affairs of the company even if their decisions contravene the express wishes of the majority shareholders."[16]

The court stated that "as long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision," and "if a board of directors has acted on the advice of a committee composed of persons having no conflict of interest, and that committee has acted independently, in good faith, and made an informed recommendation as to the best available transaction for the shareholders in the circumstances, the business judgment rule applies" and the court will not intervene with the decision of the board of directors.[17]

With this premise, the court explored whether or not the directors successfully took steps to avoid a conflict of interest.[18] The court found that Schneider Corp.'s special committee acted in good faith and made an informed decision. The special committee was aware of the reality that "any offer for Schneider's shares might be bettered by Maple Leaf [Foods], and that the [Schneider] Family would not sell to Maple Leaf [Foods]."[19]

In exploring whether the special committee was independent, and whether they acted in the best interest of the corporation, the court explored the potential conflict of interest from management's direct involvement in the negotiation process. The court determined that this involvement created a potential conflict of interest as management had a duty to act in the best interests of the corporation but also had personal interests, as they would be directly impacted by a change of control as employees of the corporation. The court highlighted business pragmatism in allowing management to negotiate as they were in the best position to explain the business. In addition, the negotiating members of management were guided by advisors and were not part of the special committee, which made the final recommendation to the Schneider board. The court approved the board's actions because it had, through the special committee and advisors, retained control of the process and guided management's negotiation.

In the *Pente Investment Management Ltd.* decision, the court recognized the position that the Schneider board was in. In public disclosures, the board was transparent in showing that the Schneider Family's buy-in was necessary for any sale of the corporation. The Schneider Family had clearly stated to the Schneider board that the only offer that they were willing to accept was from Smithfield, and the potential decrease in value that the corporation would face if there was no deal was a business reality that the board was forced to contend with.

The lower court also found that Maple Leaf Foods "could not have made an offer that would have been satisfactory to the Schneider Family at the time," so it did not criticize the Schneider board for not pursuing additional negotiation with Maple Leaf Foods. Although the Smithfield offer was not in the range provided by the financial advisor, due to risk adjustment, the court recognized that the facts supported the decision to proceed with the Smithfield transaction.

Conclusion

A significant shareholder may inevitably have a great deal of influence in the decision of the board of directors and the actions of the company. However, this influence does not relieve the board of directors of its obligations to manage an M&A transaction effectively and fulfill its fiduciary obligations towards the corporation.

In the *Pente Investment Management Ltd.* decision, the Schneider board did not allow the Schneider Family to take control of the process. The Schneider Family informed the board of its intentions and opinions throughout the process. The Schneider board did not use the Schneider Family's influence as the only factor in their decision making, rather the opinion of the family was only one factor (albeit a significant factor) that the board and special committee considered in their decision-making process.

This did not occur in *Chester* as KCG's board allowed Jefferies and Coleman to influence its decisions. The board did not take control of the process and did not make a decision in the best interest of the corporation. It is imperative that boards of directors involve themselves fully in any M&A process involving the corporation.

Using the *Pente Investment Management Ltd.* as guidance, if the *Chester* case had occurred in Canada, it is likely that the Canadian courts would still criticize the KCG board for letting the process control the board, rather than the board controlling the process.

ENDNOTES:

[1] *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.*, 2019 WL 2564093 (Del. Ch. 2019).

[2] *Pente Investment Management Ltd. v. Schneider Corp.*, 1998 WL 1726301 (Ont. C.A. 1998).

[3] *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.* at s. I.A.

[4] *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.* at I.E.

[5] *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.* at I.F.

[6] *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.* at I.F.

[7] *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015).

[8] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, Fed. Sec. L. Rep. (CCH) P 92525, 66 A.L.R.4th 157 (Del. 1986).

[9] *Supra* para 1 at s. II.A(2).

[10] *Supra* para 1 at s. II.A(2)

[11] *Supra* para 1 at s. II.A(2)

[12] *Supra* para 1 at s. II.A(2)

[13] *Pente Investment Management Ltd. v. Schneider Corp.* (1998).

[14] *Pente Investment Management Ltd. v. Schneider Corp.* (1998) at 7.

[15] *Pente Investment Management Ltd. v. Schneider Corp.* (1998) at 8.

[16] *Pente Investment Management Ltd. v. Schneider Corp.* (1998) at 9.

[17] *Pente Investment Management Ltd. v. Schneider Corp.* (1998) at 9.

[18] *Pente Investment Management Ltd. v. Schneider Corp.* (1998) at 10.

[19] *Pente Investment Management Ltd. v. Schneider Corp.* (1998) at 10.

SECURITIES LITIGATION SPOTLIGHT: SECOND CIRCUIT DECISION FINDS IMPLIED PRIVATE RIGHT OF ACTION UNDER THE INVESTMENT COMPANY ACT

By Richard Lincer, Robin Bergen, Adam Brenneman, & Marc Rotter

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In a recent decision, *Oxford University Bank v. Lansuppe Feeder, LLC*,[1] the U.S. Court of Appeals for the Second Circuit held that parties that enter into contracts that violate the Investment Company Act of 1940 have a private right of action under Sect. 47(b) of the Act to sue for rescission of those contracts. The Second Circuit's holding departs from prior decisions by two other Circuit courts and several district court decisions, amplifying potential contractual and litigation risks for funds and "inadvertent investment companies," as well as such entities' investors, lenders and contractual counterparties.

In *Oxford University Bank*, a private fund issuer, which otherwise would have been required to register as an investment company, relied on the Sect. 3(c)(7) exemption from the definition of "investment company" in the Act. The Sect. 3(c)(7) exemption requires, among other things, that owners of the issuer's outstanding securities be, at the time of acquisition of such securities, "qualified purchasers" (QPs) or "knowledgeable employees." Holders of a class of junior notes of the issuer alleged a violation of the exemption and sued for rescission of the indenture under which the notes were issued.

In contrast to previous decisions by the Third and Ninth Circuits,[2] the decision in *Oxford University Bank* held that Sect. 47(b) creates an implied private right of action that allows such a security holder suit for rescission. The Second Circuit identified parties to contracts violating the Act as the "class of persons" Sect. 47(b) "unambiguously" aims to protect through the creation of a private right of action.

The court emphasized, however, that this implied private right of action belongs only to a party to the contract violating the Act and not to third parties, such as holders of a different class of securities.

The scope of Sect. 47(b) is extremely broad—applying to any contract "that is made, or whose performance involves, a violation of the Act, or any rule, regulation or order thereunder." The Second Circuit's decision potentially impacts registered investment companies (RICs), unregistered investment companies organized outside the United States, and unregistered investment companies organized in the United States in different ways. Unregistered investment companies organized outside the United States are only prohibited from issuing securities to the public in the United States; as a result, the Second Circuit's decision highlights the importance of assessing the status of foreign entities under the Act at the time of offerings to U.S. investors.

The impact of this ruling is most dramatic on unregistered investment companies organized in the United States—because the Act prohibits such companies from engaging in interstate commerce, almost every contract such an entity enters into (including any issuances of securities) could be subject to rescission, highlighting the need to continually assess the status of U.S. companies under the Act. Therefore as interpreted in *Oxford University Bank*, Sect. 47(b) could impact every contract, commercial activity, and securities issuance by an alleged unregistered investment company organized in the United States (as the Ninth Circuit cautioned in *UFCW Local 1500,* "every other contract Yahoo! has entered into for the better part of a decade"[3]) and any contractual counterparty could seek to invoke the right to rescission.

Accordingly, if the *Oxford University Bank* opinion stands (absent a U.S. Supreme Court decision reconciling the conflict among the three Circuits), it will create another risk beyond enforcement actions by the Securities and Exchange Commission for companies violating the Act, their investors and counterparties, and will underscore the importance of law firms considering status under the Act when giving legal opinions as to the enforceability of contracts.[4]

ENDNOTES:

[1]*Oxford University Bank v. Lansuppe Feeder, LLC*, 933 F.3d 99, Fed. Sec. L. Rep. (CCH) P 100532 (2d Cir. 2019).

[2]*Santomenno ex rel. John Hancock Trust v. John Hancock Life Ins. Co. (U.S.A.)*, 677 F.3d 178, 52 Employee Benefits Cas. (BNA) 2807 (3d Cir. 2012); and *UFCW Local 1500 Pension Fund v. Mayer*, 895 F.3d 695, Fed. Sec. L. Rep. (CCH) P 100221 (9th Cir. 2018).

[3]*UFCW Local 1500 Pension Fund v. Mayer* (2018).

[4]This issue has previously been highlighted by the TriBar report on Third-Party "Closing" Opinions, but it is of renewed importance in light of the Second Circuit's recent opinion. TriBar Opinion Committee, Third-Party "Closing" Opinions, 53 Bus. Law. 592, 628 ("Similarly, the opinion preparers should consider the effect of the Investment Company Act of 1940 when preparing an opinion on the binding effect of an agreement on a registered investment company. . . .The opinion preparers should also consider the application of the Act if they recognize that the Company's activities may make it an inadvertent investment company.").

REGULATING & PROVIDING BANKING SERVICES TO MARIJUANA, HEMP & CBD-RELATED BUSINESSES: IT'S COMPLICATED

By Gina Jurva

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Complicated is an understatement when it comes to deciphering the current regulatory and enforcement ecosystems around marijuana, hemp, and cannabidiol ("CBD"). As you might have guessed, the laws aren't the same, and the differences between them are complicated.

Many cannabis-related businesses struggle to find bankers because marijuana is still considered wholly illegal as a Schedule 1 drug by the federal government.[1] More than 30 U.S. states have legalized marijuana for medical use, and there are currently 11 states that allow the usage and sale of recreational marijuana, including most recently Illinois.[2] The 2018 Farm Bill legalized hemp, subject to new rules and regulations that are still being written and not yet implemented at the federal or state level. And CBD remains in a dubious legal gray area.

Hence, the legality of cannabis and cannabis-related products remains opaque at best. Yet, that hasn't stopped sales from booming. Researchers estimate the U.S. market for marijuana could reach $25 billion to $30 billion by 2023[3] while CBD alone could surge anywhere from $16 billion to $24 billion by 2023.[4]

Why this Matters for Financial Institutions

Financial institutions are required to follow anti-money laundering regulations set forth by Financial Crimes Enforcement Network ("FinCEN"). FinCEN has issued guidance that those that work with marijuana-related businesses are required to perform enhanced due diligence, a level of risk analysis, and on-going monitoring for that customer type, all while marijuana remains illegal. Moreover, institutions must file suspicious activity reports ("SARs") and currency transaction reports as events warrant. While FinCEN hasn't provided any guidance on hemp or CBD yet, given the close family proximity to marijuana, most financial institutions are taking a similarly conservative, if not completely "hands off" approach until further guidance, acceptance, or industry maturity occurs.

Interestingly, for financial institutions seeking clients in marijuana businesses, the guidance and requirements are arguably clearer for marijuana (meaning, an enhanced screening and reporting requirement) than for CBD or hemp, which, while legal or quasi-legal, have less history behind them. But what about CBD oil? What about the bodega on the corner selling CBD products? Are they also required to file a SAR with FinCEN?

To help make some sense of this conundrum, I spoke with Steven Kemmerling, CEO of CRB Monitor, a corporate intelligence platform that helps financial institutions more effectively understand, identify, and manage potential risks and opportunities related to the emerging "legalized" cannabis industry, including marijuana, hemp, and CBD.

Cannabis Language Decoder

But first . . . a language primer. Aren't cannabis and marijuana the same thing? How about cannabis and hemp?

Well, yes. Marijuana *derives* from cannabis. Hemp *derives* from cannabis. Kemmerling says the main difference between hemp and marijuana is the Tetrahydrocannabinol ("THC") content—the psychoactive ingredient which gives the user the "high" feeling.

"Cannabis is the plant; *Cannabis sativa L.*," Kemmerling says. "Marijuana and hemp are different varieties of the same *Cannabis sativa L.* plant. Like with a tomato, there are different variations." He explains that "marijuana" is the legal term for cannabis with THC measured over 0.3%; and "hemp" is the legal term for cannabis with less than or equal to 0.3% THC.

And what is CBD?

CBD is a compound that comes from cannabis—either "hemp" or "marijuana," he says. And this is where the legality gets murky. "The 2018 Farm Bill also removed hemp-derived products from Schedule I status under the Controlled Substances Act ("CSA"),[5] but did not exactly legalize CBD. To be fully legal, CBD has to be derived from hemp grown legally under the Farm Bill and produced and sold consistent with other federal and state-specific laws and regulations, including U.S. Food & Drug Administration ("FDA") rules."

FDA Principal Associate Commissioner for Policy Lowell Schiller recently said that the FDA retains regulatory authority over hemp-derived products, and it remains illegal to introduce CBD in the food supply or as dietary supplements unless the agency develops alternative rules. Because CBD exists as an FDA-approved epilepsy drug, Epidiolex, creating a regulatory framework is more complicated. "If a CBD product can be proven to contain less than 0.3% THC, comes from a legal hemp grower, is sold in a state without hemp/CBD restrictions (For example, South Dakota says both hemp and CBD are still illegal), and is not used in a way that conflicts with the FDA, then it might be legal," explains Kemmerling, pointing to a recent analysis that indicates upwards of 90% of CBD businesses are operating in FDA "Gray Area."

However, if CBD is extracted from marijuana, it is arguably illegal because you can't produce a "legal" product derived from an illegal source, he adds.

Now that we have the language down, let's try to understand the regulation, and let's begin with marijuana. If marijuana is legal in some states, shouldn't marijuana-related businesses ("MRBs") be able to get banking services instead of hauling around large amounts of cash?

Unfortunately, many banks are still concerned with violating anti-money laundering statutes and taking on risk, including hypothetically losing their Federal Deposit Insurance Corporation ("FDIC") insurance protection, although those fears may be easing somewhat because there is no instance in which this has happened.

Kemmerling says he's personally seen and heard regulators from multiple agencies, including the FDIC, Office of the Comptroller of the Currency, Federal Reserve Board, and the National Credit Union Administration say that they would not pull a bank's FDIC insurance or generally penalize a bank for "just" banking marijuana—if the banks follow the guidance set forth by FinCEN and implement effective and robust policies and procedures.

Indeed, the possible federal laws financial institutions can violate if they offer banking services to marijuana-related businesses include the CSA, the U.S. Patriot Act, the Bank Secrecy Act, and the Racketeer Influenced and Corrupt Organizations Act.

Kemmerling says the riskiest marijuana-related businesses ("MRBs") for banks to server are those that literally touch marijuana at some point along the supply chain and most clearly manufacture, distribute, or dispense marijuana. Those companies are generally referred to as "Direct" MRBs by FinCEN. or "Tier 1" by Kemmerling. However, "Indirect"—called "Tier 2" or "Tier 3" companies—also pose a risk to financial institutions as they arguably "aid and abet" the illegal activity taking place at the Direct/Tier 1 MRBs.

Hemp: Let's Get Growing *and* Banking

What about hemp? Isn't hemp legal? President Donald Trump signed the 2018 Farm Bill into law, which effectively made hemp legal by removing it from the CSA and created a pathway for each state to create full-scale hemp production programs versus limited "pilot" research programs authorized under the 2014 Farm Bill.

But, again, it's not quite that simple, says Kemmerling. The 2018 Bill did remove hemp from the CSA, but there are there caveats and restrictions. Hemp must contain less than 0.3% of Tetrahydrocannabinol ("THC"), the psychoactive ingredient which gives the user the "high" feeling. Farmers who want to cultivate and grow hemp must secure a license either through their state (if available) or through the U.S. Department of Agriculture ("USDA"), (if their state does not have a program and *does not* otherwise restrict hemp cultivation). However, each state must create its own hemp program and submit it to the USDA for review and approval, subject to rules and regulations that the USDA has not yet completed writing. Hence, anyone cannot just start growing hemp in their backyards like tomatoes. The final rules from the USDA under the 2018 Farm Bill aren't yet written, let alone in effect, but are expected to be completed by the end of 2019 and implemented in the 2020 planting season.

Until then, farmers need to follow the "pilot" regulations under the 2014 Farm Bill, Kemmerling says, and that difference does matter. "The 2014 Farm Bill didn't legalize wholesale commercialization or interstate commerce," he explains. "But instead allowed pilot research programs to study industrialized hemp."

Bottom line—there is on-going uncertainty regarding hemp rules, regulations, licensing, and enforcement. And that confusion is likely to remain until the 2018 Farm Bill is fully in place.

The Final Word

Due to conflicting and still evolving federal and state laws, most cannabis-related businesses—including marijuana, hemp and CBD—remain cash-intensive and are perceived as very risky, if not illegal operations.

However, that perception and reality are slowly changing. Indeed, financial institutions' compliance officers need to be aware of and follow various legislative and political developments related the 2018 Farm Bill and other regulations like the SAFE Banking Act of 2019,[6] which would forbid federal banking regulators from penalizing banks and credit unions for simply providing financial services to legitimate marijuana-related businesses.

ENDNOTES:

[1]*See* U.S. Department of Justice, List of Controlled Substances; *available at* https://www.deadiversion.usdoj.gov/schedules.

[2]Pierog "Illinois joins 10 other U.S. states in legalizing recreational marijuana," Reuters Health News (June 25, 2019).

[3]McVey "Exclusive: US retail marijuana sales on pace to rise 35% in 2019 and near $30 billion by 2023," Marijuana Business Daily (Published May 30, 2019).

[4]Giammona and Einhorn "Booming Demand for CBD Is Making Hemp the Cannabis Cash Crop," Bloomberg Businessweek (July 18, 2019).

[5]The Controlled Substances Act, Pub. L. 91-513; 84 Stat. 1236 (1971).

[6]*See* H.R. 1595: SAFE Banking Act of 2019, *available at* https://www.govtrack.us/congress/bills/116/hr1595.

RECENT TRENDS IN U.S. SECURITIES CLASS ACTION LITIGATION: H1 2019 UPDATE

By Svetlana Starykh & Janeen McIntosh

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New federal securities class action filings in the first six months of 2019 indicate that annual filings are on track to be similar to the number of new cases filed in each of the prior two years. While we observed a relative surge in new cases in the first quarter of the year, this higher level of new cases did not persist in the second quarter.

Filing activity in the first half of 2019 indicates a continuation of the shift in the types of cases observed in 2018—an increasing number of the standard (Rule 10b-5, Section 11, or Section 12) cases and a decreasing number of merger objections. If the filing composition and levels observed in the first half of 2019 are an indication of the pattern for the rest of the year, we may find a 15% increase in Rule 10b-5, Section 11, and Section 12 cases compared to the approximate 1% growth in this category of filings in 2018.

On the other hand, merger-objection cases filed in 2019 are on pace to be more than 16% lower than similar cases filed in the prior year.

In 2018, one in 12 publicly traded companies were subject to securities class action. Based on the H1 2019 filing rate, publicly traded companies may have a similar litigation risk. However, the risk of merger-objection litigation is specific to firms planning or engaged in M&A activity. During the first six months of 2019, there were 3,699 merger announcements and only 83 merger-objection cases filed. Based on this recent data, we find that only 1-in-45 companies planning a merger are being sued.

The split of non-merger-objection class actions filed in H1 of 2019 across the economic sectors is fairly consistent with the distribution observed in 2018, with no indication of any shifts or increases in particular sectors. As in 2018, the Health Technology & Services and the Electronic Technology & Technology Services economic sectors accounted for more than 40% of filings.

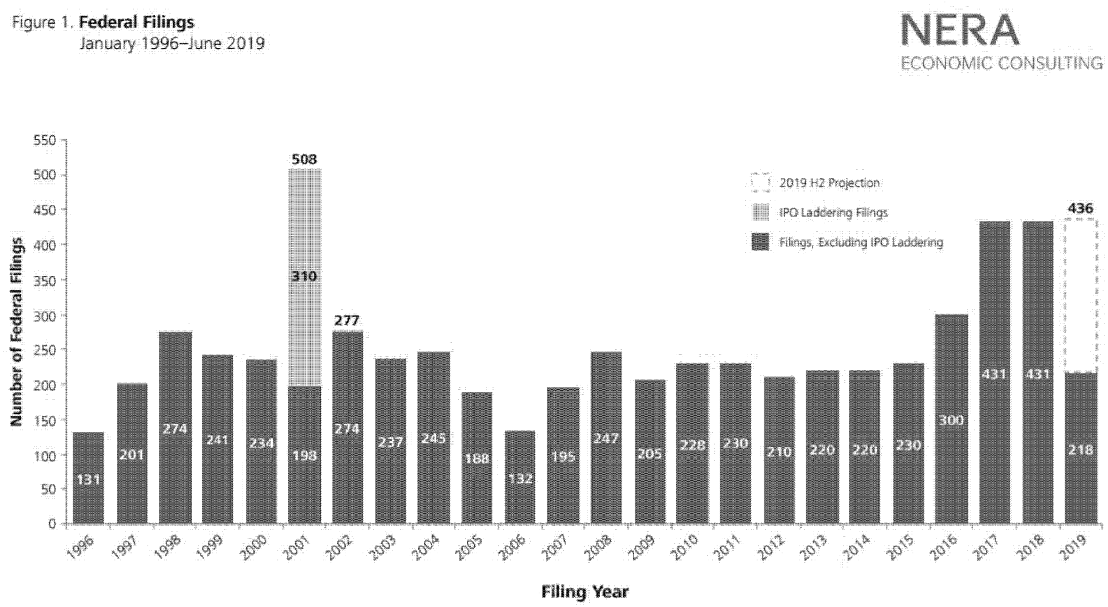
The aggregate NERA-defined investor losses associated with 2019 filings thus far suggest that the new filings for the full year may be larger than the cases in 2017 but lower than in 2018, even excluding the outlier 2018 General Electric case.[1] For the full year of 2018, there were nearly three times as many cases with NERA-defined investor losses in excess of $10 billion compared to the first half of 2019.

If resolution activity between January and June reflects the pattern for the rest of 2019, resolutions for the full year will be lower than the 2017 and 2018 levels but higher than in 2016. Despite the overall lower resolutions, the number of cases dismissed is on pace to be higher than the number of dismissals in 2017. Settlements, on the other hand, are on pace to reach approximately 100 for the full year—the lowest level of settlements observed in any one year since 2012.

During the first half of 2019, the average settlement declined to $33 million, more than 50% lower than the average in 2018 but higher than the average in 2017. However, this phenomenon is primarily driven by the fact that the *Petrobras* settlement[2] for $3 billion was finalized in 2018 and heavily skewed the average for that year. If we limit to cases with settlements under $1 billion—and thus exclude the *Petrobras* settlement in 2018—we found a slight increase in the average settlement value in 2019 compared to the prior years.

The median settlement value for cases was $12 million, which is in line with the median in 2018 but almost double the median value in 2017.

Figure 1. **Federal Filings**
January 1996–June 2019



ENDNOTES:

[1]*See*, for most recent developments, Scott, "General Electric wins partial dismissal of shareholder lawsuit"; Reuters (Aug. 29, 2019); *available at* https://www.reuters.com/article/us-ge-lawsuit/general-electric-wins-partial-dismissal-of-shareholder-lawsuit-idUSKCN1VJ2QH.

[2]Brendan Pierson, "Petrobras to pay $2.95 billion to settle U.S. corruption lawsuit," Reuters; Jan. 3, 2018; *available at* https://www.reuters.com/article/us-petrobras-classaction/petrobras-to-pay-2-95-billion-to-settle-u-s-class-action-over-corruption-idUSKBN1ES0L2.

SEC SPEECH: THE DYNAMICS OF OUR MARKETS & THE CHANGING STRUCTURE ON WHICH THEY ARE BUILT

From SEC Commissioner Elad L. Roisman

Securities and Exchange Commissioner (SEC) Elad L. Roisman spoke at the Securities Industry Financial Markets Association's (SIFMA's) Equity Market Structure Conference on September 19 in New York City. This article is a partial transcription of his comments.

[. . .] Market structure—especially that of our equity markets—has always been a topic of great interest to me and one about which I care deeply. Each year, I look forward to the fall, not only because it brings great weather, but also because it kicks off what I like to think of as "Equity Market Structure Season." This is a time (usually beginning with this conference) when stakeholders from all corners of our markets gather and discuss ways to make them better.

This year, the season is particularly exciting. Many of the issues that have been raised repeatedly since the adoption of Regulation NMS—and discussed and scoped over many years—are now very much on the SEC's radar. For this, I credit SEC Chairman Jay Clayton and Brett Redfearn, the Director of the SEC Division of Trading and Markets. . . . Together, they have moved equity market structure to the top of the Commission's agenda. I encourage you to read the Chairman's and Director Redfearn's March 2019 speech, which addressed several issues we grappled with over the past year and discussed potential steps for the future.[1]

To put things into perspective, the SEC proposed Regulation NMS more than 15 years ago.[2] Much of the debate and consideration that went into that proposal, and ultimately its adoption, had been going on for several years before that. We also are nearly 10 years removed from the SEC's equity market structure concept release.[3] Not only does this remind us all of how old we have become, but also that discussions like these likely will continue for several years after our time in this space ends and others fill these roles and seats. Nevertheless, my hope is we can tackle several of these issues in the near term and finally put them to rest (at least for some time).

Today, I am honored to begin Equity Market Structure Season with a few remarks on existing regulation. I will start by focusing particularly on broker-dealers' best execution obligations and the "Order Protection Rule" (OPR).[4] Then, I will offer a few ideas on other areas of the securities markets that are of interest to me. Along the way, I will pose some questions that could help regulators better consider these areas.

Structure vs. Dynamics

When I hear the term "market structure," I think stability and reliability. In my view, our markets have structure now and have for quite some time. Our markets work incredibly well and mostly as intended. Because of this, our equity markets are the envy of the world. This stability and reliability are key factors that drive so many companies to raise capital in the U.S. and cause investors to feel more comfortable investing in the market. But maintaining stability and reliability requires vigilant attention. Our markets are constantly evolving and, like many things in life, just when we think we have it all figured out, some unforeseen or unlikely development brings us back to the drawing board. Unintended consequences can result from new or modified regulation—I will elaborate on this in a moment.

As a regulator, it is incumbent upon me and my fellow Commissioners to ready our agency and prepare our markets so that we can respond to the unforeseen and foster resiliency. As one of the Commissioners of the SEC, I must also promote the agency's tripartite mission of investor protection, maintaining fair, orderly, and efficient markets, and facilitating capital formation. Our equity markets play a pivotal role in achieving all three components of this mission.

We must strive to ensure that our markets and our regulations keep pace with innovation and change. We rely on the tremendous staff of the SEC's divisions and offices to help us do this. You, your colleagues, and the organizations you represent also play pivotal roles. Your insight and stewardship are vital to ensuring that our markets not only keep pace with changes in market trends and technology, but that they are resilient no matter the conditions.

It's All Connected

It is fitting that Equity Market Structure Season begins in the autumn, when we all pull sweaters out of our closets. I often think of the laws and regulations that govern our industry like the woven threads in a sweater. Pulling to tighten one typically loosens another elsewhere. Sometimes those effects are intended. At other times, however, they are not. And, the unintended effects may even be more significant than those we had aimed to produce in the first place. I am mindful of this interconnectedness, and it factors into my decision-making when I consider new or amended rules and guidance for our markets and their participants. I will elaborate on this by sharing a few thoughts on best execution, OPR, and other evolving areas of our markets.

Best Execution

It is a longstanding principle that a broker-dealer has a legal duty to seek to seek to obtain best execution of customer orders.[5] The SEC takes broker best execution obligations very seriously, and our Division of Trading and Markets previously has stated that the "obligation constitutes one of the cornerstones of market integrity."[6]

In my conversations with firms during my first year as a Commissioner, it became clear to me that the duty of best execution is one that brokers, and the rest of the industry also take seriously. It is pervasive in the routing decisions they make every nanosecond of the trading day. I have heard several firms point to best execution as a primary driver of why they take certain actions or, conversely, as the basis for why they are unable to pursue otherwise seemingly practical alternatives to the existing way of doing things. Take, for example, exchange proprietary data feeds and the feeds from the securities information processors (SIPs). I often hear, both from brokers and asset managers, that they would not consider best execution satisfied if the SIPs are used for pricing in broker routing algorithms. Some say this is because of the lag in the SIPs versus proprietary feeds. Others point to the richer content in proprietary feeds compared to "Core Data" in the SIPs.

I think we can all agree that best execution is incredibly important. But what exactly is best execution? I ask this rhetorical question knowing full well that the duty is intended to be principles-based on an order-by-order basis. Nevertheless, I think the Commission should consider setting forth a non-prescriptive interpretation of, or guidance on, the *regulatory* requirement to achieve "best execution." I emphasize regulatory requirement because I believe, in general, there should be a difference between what regulation requires and what businesses do for commercial reasons. Regulation sets a baseline that should apply across a variety of market niches and throughout different market conditions. Commercial demand, on the other hand, varies across different customer types and cycles of the economy. I believe regulation should set a baseline and allow for firms to go further than what is required to satisfy best execution, when they choose to do so for commercial purposes.

The premise of best execution is to seek the most favorable terms for a customer's transaction under the circumstances. In many circumstances, price and speed ultimately may be determinative inputs after a broker analyzes its regulatory best execution requirements. Rule 605 under Regulation NMS specifically mentions execution price and speed.[7] But the SEC has previously cited many other aspects of a broker's routing decision that are factors in obtaining best execution of customer orders. These include size, availability of information, trading characteristics of the security, transaction costs, and ease of getting a fill.[8] Going beyond the SEC, the Financial Industry Regulatory Authority (FINRA) cites several other factors surrounding best execution, including price improvement opportunities, differences in price disimprovement, the likelihood of execution of limit orders, customer needs and expectations, and the existence of internalization or payment for order flow arrangements.[9]

And yet my concern is that, for some, the focus on price and time and the avoidance of trade-throughs has become a substitute for a more robust best execution analysis—the notion being, that if brokers simply seek the best price at a given moment, other variables are less important, or perhaps more difficult for a regulator or customer to criticize. I recognize that some of this may result from a weighing of risk, both from a regulatory standpoint and also commercially. Whereas several best execution factors are subjective in nature, and perhaps defensible under scrutiny, price is relatively cut and dry. But price is just one factor in a best execution analysis, not only when firms make routing decisions, but also when regulators review these decisions after the fact. Finally, some have noted that this framework for regulator review of best execution often has been process-oriented—*i.e.*, requiring that brokers show their work—rather than focused on outcomes for customers. Is this how we should continue to think about best execution, or should we focus more on outcomes? For example, what if a broker accesses a quote with relatively small size, perhaps to satisfy OPR, but by doing so chases off a larger order that may have more closely achieved best execution for the customer? Should there be some combination of approaches, such as a safe harbor for certain outcomes?

I think investors, our markets, and the industry as a whole would benefit from this Commission saying more on broker best execution, especially if the current lack of guidance may hinder the ability of firms to satisfy best execution in a flexible, practical, and principles-based manner. Past Commissions generally have refrained from defining best execution. For example, the Commission that adopted legacy Rule 11ac1-5, the predecessor to Rule 605, noted that it was "not defin[ing], either explicitly or implicitly, a broker-dealer's duty of best execution."[10] There also were several requests for clarification of a broker-dealer's duty of best execution when the SEC proposed Regulation NMS.[11] Ultimately, however, that Commission chose not to provide further guidance on best execution, but instead explained the history and background on the obligation.[12]

Given where we are today, with so much focus on price and investment into achieving high speeds, I believe further guidance is needed. I am particularly interested in your views on best execution and OPR in tandem. For example, has OPR inhibited certain trading behavior that may have otherwise achieved best execution? Perhaps worse, has OPR required other behavior that may have even impeded best execution? These are additional examples of that push and pull—cause and effect—inherent in our regulatory process. I encourage you to share your thoughts on best execution, as a regulatory requirement and as you pursue it from a commercial standpoint in your businesses.

Order Protection Rule

As for OPR, I would like the Commission to take a closer look at the rule and its effect on our markets, and to consider whether minor adjustments or more significant changes are appropriate. The SEC's Strategic Plan notes the importance for the SEC to "continually analyze and seek feedback from investors and others about where rules are, or are not, functioning as intended."[13] I think this review should include the OPR.

When the SEC approved Regulation NMS in 2005, it could not have envisioned that 14 years later there would be 13 active equity exchanges, with a 14th recently approved,[14] and two more rumored in the works,[15] as well as more than 30 alternative trading systems. Despite the growth in numbers, of those 13 exchanges, the two largest by volume generally account for approximately 30% of average daily trading volume (ADV) industry-wide.[16] Drilling down further, three exchange groups control 12 of the 13 active markets and account for nearly 60% of ADV.[17] However, excluding the dominant exchange from each of those three operators (or the two most dominant in the case of), each remaining exchange accounts for significantly lower percentages of ADV.[18]

On the one hand, I think it is wonderful and important that our regulations may have encouraged competition, evolution, and innovation in the exchange space. However, the equity markets also have undergone significant consolidation in recent years—with certain exchange operators acquiring other markets that previously operated independently. The statistics I just mentioned show that a handful of dominant exchanges continue to attract the majority of on-exchange trading volume (albeit less so than before Regulation NMS when it was just two dominant players). But with OPR, brokers are inherently forced to connect to, purchase market data from, and take into account prices on all exchanges. This is the case whether or not each particular exchange is independent or if it is one of three, four, or even five controlled by the same operator. This also is irrespective of the volume on that market or the relative size at the National Best Bid or Offer.

All of this leads me back to OPR. Is OPR, as it exists today and in this environment, best for investors? For brokers? For exchanges themselves? When the Commission adopted OPR, it noted that OPR was established to protect against trade-throughs for all NMS stocks and to protect only quotations that are immediately accessible through automatic execution. Considering the original rationale for OPR and the mostly electronic nature of our markets today, is OPR still needed? If the SEC were to set forth clearer expectations on best execution, how would that affect the use case for OPR? If we think OPR still serves an important purpose, should we think about any adjustments? Perhaps we should increase the number of round lots needed to qualify as a protected quotation? Or conversely, for expensive stocks, maybe we should consider reducing the number of shares needed to qualify as a round lot? What if we created an exemption for block-size orders? Should OPR apply only to exchanges that reach a specific, minimum ADV over a set period of time? On this last point, if we were to go down that path, should we consider some regulatory action to encourage new entrants and to protect the smaller markets that exist today and the roles they serve?

These are just a few ideas to spur conversation—I am not committed to any of them. But I do feel strongly that, since we have lived with OPR for nearly 15 years, we should use the data and experience we have accumulated to reexamine it.

New Territory

I have named two areas of existing equity market structure regulation that I believe we need to reassess generally. Now, I will mention two more that interest me, and pose a few questions for your consideration.

First, I would like to talk about order management systems (OMSs), which many buy side firms use for various functions, including to connect with trading counterparties and to manage the lifecycle of their orders. OMSs are used extensively in our equity markets, including for the deployment of brokers' routing algorithms. Clearly, they are performing services that market participants value, and they have become interwoven into the equities environment. I would like to better understand this thread running through the equities markets. What services are OMSs performing that used to be performed by other players that we directly regulate, such as broker-dealers, exchanges, ATSs, etc.? If these services are getting consolidated, does that raise new risks to investors or our markets that our existing regulations were intended to address? Since broker-dealers and advisers are still on the hook for all of their compliance obligations, how are they conducting due diligence and overseeing these OMS providers when they perform such services? Also, I have heard concerns regarding the opacity and pricing of OMS vendors. Notably, given asset managers' own best execution obligations,[19] how are advisers thinking about the fees they and their brokers pay to OMS providers? At a threshold level, are OMS fees adequately transparent for their consideration?

Now, I will wind up my remarks by moving beyond our public equities markets to discuss what has been known to be a regulatory gray area for some time. I believe we need to consider the role of "finders"—those who help small businesses, seeking to raise capital, identify and locate potential investors (typically for a fee). Finders can play an important role in filling the gap to help small businesses obtain early stage financing. But the regulatory framework that governs them has been ambiguous at best. On the one hand, the role of these companies or individuals is akin to that of a broker, including that they receive transaction-based compensation, but they are not subject to the same requirements as broker-dealers. On the flip side, they frequently do not handle securities or funds, rendering the purpose of some broker-dealer requirements inapplicable.

I believe it is time for the SEC to put some clear rules in place, not just staff no-action letters and enforcement actions, so that we can clarify for our markets and investors the benefits and obligations of finders. Such clarity would also allow finders to operate with greater certainty and would give issuers peace of mind that their offerings are not being facilitated by unregistered brokers. [. . .]

ENDNOTES:

[1]Clayton and Redfearn, "Equity Market Structure 2019: Looking Back & Moving Forward" (Mar. 8, 2019), available at https://www.sec.gov/news/speech/clayton-redfearn-equity-market-structure-2019.

[2]The Commission adopted Regulation NMS in 2005. See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (Regulation NMS Adopting Release). The Commission originally proposed Regulation NMS in February 2004. See Securities Exchange Act Release No. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) (Regulation NMS Proposing Release). The Commission issued a supplemental request for comment in May 2004. *See* Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004). In December 2004, the Commission reproposed Regulation NMS in its entirety for public comment. *See* Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004).

[3]*See* Securities Exchange Act Release No. 61358 (Jan. 14, 2010), 75 FR 3594 (Jan. 21, 2010).

[4]Rule 611 under the Securities Exchange Act of 1934 (Exchange Act).

[5]*See, e.g.*, Regulation NMS Adopting Release at 37537, note 338. See also Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996).

[6]*See* Division of Market Regulation, *Market 2000: An Examination of Current Equity Market Developments*, *available at* https://www.sec.gov/divisions/marketreg/market2000.pdf.

[7]Exchange Act Rule 605. This rule generally requires a market center that trades NMS stocks to make available to the public monthly electronic execution reports that include uniform statistical measures of execution quality. *See, e.g.*, Rule 605 "FAQs," *available at* https://www.sec.gov/divisions/marketreg/nmsfaq605.htm.

[8]*See*, *e.g.*, Securities Exchange Act Release No. 43590 (Nov. 17, 2000), 65 FR 75414, 75418 (Dec. 1, 2000).

[9]*See*, *e.g.*, FINRA Rule 5310.

[10]*See* supra note 8.

[11]*See*, *e.g.*, Regulation NMS Adopting Release at 37537, note 336.

[12]*See* Regulation NMS Adopting Release at 37538. "At the same time, however, the Commission recognizes the validity of concerns expressed by commenters with respect to the need for guidance concerning their best execution responsibilities after implementation of Regulation NMS." See also Regulation NMS Adopting Release at 37538, note 340.

[13]*See* U.S. Securities and Exchange Commission, Strategic Plan, Fiscal Years 2018-2022 (Oct. 11, 2018), *available at* https://www.sec.gov/files/SEC_Strategic_Plan_FY18-FY22_FINAL_0.pdf.

[14]*See* Securities Exchange Act Release No. 85828 (May 10, 2019), 84 FR 21841 (May 15, 2019).

[15]*See*, *e.g.*, https://www.prnewswire.com/news-releases/group-of-leading-retail-brokers-financial-services-firms-banks-and-global-market-makers-plan-to-launch-the-only-member-owned-equities-exchange-memx-members-exchange-300773713.html; https://www.marketsmedia.com/miax-parent-to-launch-equities-exchange/.

[16]*See*, *e.g.*, https://markets.cboe.com/us/equities/market_statistics.

[17]https://markets.cboe.com/us/equities/market_statistics.

[18]https://markets.cboe.com/us/equities/market_statistics.

[19]*See*, *e.g.*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019), 84 FR 33669 (July 12, 2019).

SEC/SRO UPDATE: SEC PROPOSES AMENDMENTS TO MODERNIZE BUSINESS, LEGAL PROCEEDINGS & RISK FACTOR DISCLOSURES UNDER REGULATION S-K; SEC CLARIFIES INVESTMENT ADVISERS' PROXY VOTING RESPONSIBILITIES & APPLICATION OF PROXY RULES TO VOTING ADVICE; SEC INCREASES FEE RATES FOR FISCAL YEAR 2020

By Peter H. Schwartz & Laura Pflumm Cerezo

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SEC Proposes Amendments to Modernize Business, Legal Proceedings & Risk Factor Disclosures Under Regulation S-K

On August 8, the Securities and Exchange Commission (SEC) proposed rule amendments to modernize the description of business (Item 101), legal proceedings (Item 103), and risk factor (Item 105) disclosures that companies are required to make pursuant to Regulation S-K.[1]

The proposed amendments would revise Items 101(a), 101(c), and 105 to emphasize a more principles-based approach to disclosure by focusing on information that is material to an investor's understanding of a company's business. The proposed amendment to Item 103 would continue the existing prescriptive approach to disclosure since such disclosure depends less on specific characteristics of companies.

A summary of these proposed amendments is provided below:[2]

Description of Business—General Development (Item 101(a))

The proposed amendments would:

- provide a non-exclusive list of the types of information that a company may need to disclose to the extent such information is material to understanding the general development of a company's business (including three topics currently covered by Item 101(a)(1)—material bankruptcy proceedings, the nature and effects of any material merger or consolidation of the company, and the acquisition or disposition of any material amounts of a company's assets—and a new topic, disclosure of transactions and events that affect or may affect the company's operations, including material changes to its previously disclosed business strategy);
- eliminate the five-year disclosure timeframe and focus instead on material developments of a company's business, regardless of a specific timeframe; and
- permit a company, after the filing of its initial registration statement, to provide only updated disclosures of material developments of the business in a given reporting period, along with an active hyperlink to the company's most recent filing that would, together with the update, seek to provide a full discussion of the general development of the business.

Description of Business—Narrative Description (Item 101(c))

The proposed amendments would:

- provide disclosure topics drawn from a subset of the topics currently contained in Item 101(c) (*e.g.*, revenue-generating activities, products and/or services, and dependence on key products, services, product families or customers) and new disclosure topics, and clarify that disclosure of such topics would only be required if the information is material to an understanding of the general development of the company's business;
- require, to the extent material, new disclosures regarding "human capital resources," including any human capital measures or objectives that a company's management team focuses on in managing the business, such as, depending on the nature of the company's business and workforce, measures or objectives that address the attraction, development, and retention of personnel; and
- expand the current requirement to disclose the impact of environmental regulations to cover all material government regulations.

Legal Proceedings (Item 103)

The proposed amendments would, among other changes:

- clarify that required information about material legal proceedings may be provided by including hyperlinks or cross-references to legal proceedings disclosure elsewhere in the document (*e.g.*, notes to the financial statements) to avoid repetitive disclosure; and
- increase the threshold for environmental proceedings involving governmental parties from $100,000 to $300,000 to adjust for inflation.

Risk Factors (Item 105)

The proposed amendments would, among other changes:

- require a summary of the risk factor section if it exceeds 15 pages;
- replace the requirement to disclose the "most significant" risk factors with "material" risk factors to focus on risk that are important to investors in making an investment decision; and
- require risk factors to be organized under relevant headings, with any risk factors generally applicable to an investment in securities disclosed at the end of the risk factor section under a separate caption, to help investors better understand lengthy risk factor disclosures.

The full proposed rule amendments will be subject to a 60-day public comment period.

SEC Clarifies Investment Advisers' Proxy Voting Responsibilities & Application of Proxy Rules to Voting Advice

On August 21, the SEC provided guidance (Guidance) that seeks to assist investment advisers in fulfilling their proxy voting responsibilities particularly where the adviser uses the services of a proxy advisory firm.[3] The Guidance discusses, among other matters:

- the ability of investment advisers to establish a variety of different voting arrangements with their clients;
- matters that advisers should consider when using a proxy advisory firm; and
- proxy voting disclosures under certain forms used by investment companies subject to the Investment Company Act of 1940, as amended.

The SEC also issued an interpretation (Interpretation) stating that, in the SEC's view, proxy voting advice provided by proxy advisory firms generally constitutes a "solicitation" under the federal proxy rules. The Interpretation was accompanied by related guidance about the how proxy voting advice is subject to the "Proxy Antifraud Rule" codified as Rule 14a-9 under the Securities Exchange Act of 1934, as amended (the Exchange Act).

Guidance: Proxy Voting Responsibilities of Investment Advisers

The Guidance follows a question and answer format and provides examples to help facilitate compliance. Some of the questions raised in the Guidance include:

- *Allocation of Authority and Responsibilities*: How an investment adviser and its client, in establishing their relationship, may agree upon the scope of the investment adviser's authority and responsibilities to vote proxies on behalf of that client;
- *Documentation of Voting Determinations*: What steps an investment adviser, who has assumed voting authority on behalf of clients, could take to demonstrate it is making voting determinations in a client's best interest and in accordance with the investment adviser's proxy voting policies and procedures;
- *Considerations When Hiring a Proxy Advisory Firm*: Considerations that an investment adviser should take into account if it retains a proxy advisory firm to assist it in discharging its proxy voting duties;
- *Awareness of Weaknesses in Proxy Advisory Firm Recommendations*: Steps for an investment adviser to consider if it becomes aware of potential factual errors, potential incompleteness, or potential methodological weaknesses in the proxy advisory firm's analysis that may materially affect one or more of the investment adviser's voting determinations;
- *Evaluation of Proxy Advisory Firms*: How an investment adviser could evaluate the services of a proxy advisory firm that it retains, including evaluating any material changes in services or operations by the proxy advisory firm; and
- *Scope of Adviser Voting Authority and Requirement to Vote Each Proxy*: Whether an investment adviser who has assumed voting authority on behalf of a client is required to exercise every opportunity to vote a proxy for that client.

Interpretation: Applicability of the Federal Proxy Rules to Proxy Voting Advice

In the Interpretation, the SEC noted that the federal proxy rules apply to any "solicitation" for a proxy with respect to any security registered under Section 12 of the Exchange Act. Under these rules, a "solicitation" includes, among other things, a "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy," and includes communications by a person seeking to influence the voting of proxies by shareholders, regardless of whether the person itself is seeking authorization to act as a proxy.

Under the Interpretation, proxy voting advice provided by proxy advisory firms generally constitutes a "solicitation" subject to the federal proxy rules. The Interpretation does not affect the ability of proxy advisory firms to continue to rely on the exemptions from the federal proxy rules' filing requirements. These exemptions, among other things, provide relief from the obligation to file a proxy statement, as long as the advisory firm complies with the exemption's conditions.

Solicitations that are exempt from the federal proxy rules' filing requirements remain subject to Exchange Act Rule 14a-9, which prohibits any solicitation from containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact. The related guidance explained what a person providing proxy voting advice should consider when considering the information that may need to be disclosed in order to avoid a potential violation of Rule 14a-9 where the failure to disclose such information would render the advice materially false or misleading.

The Guidance and Interpretation each became effective on September 10, the day they were published in the Federal Register.

SEC Increases Fee Rates for Fiscal Year 2020

On August 23, the SEC announced that it is raising the fees it charges public companies and other issuers to register their securities. In fiscal 2020, which began on October 1, 2019, the fee rates for the registration of securities and certain other transactions will be $129.80 per million dollars, up from $121.20 per million dollars last year.[4]

The SEC is required to make annual adjustments to the rates for fees paid under Section 6(b) of the Securities Act of 1933 and Sections 13(e) and 14(g) of the Exchange Act. The rates are set to levels the SEC projects will generate collections equal to annual statutory target amounts calculated using a methodology developed in consultation with the Congressional Budget Office and the Office of Management and Budget.

The projected statutory amount for fiscal year 2020 is $705 million. Therefore, effective October 1, 2019, the Section 6(b) fee rate applicable to the registration of securities, the Section 13(e) fee rate applicable to the repurchase of securities and the Section 14(g) fee rate applicable to proxy solicitations and statements in corporate control transactions will increase to $129.80 per million dollars.

ENDNOTES:

[1]*See* SEC Press Rel. No. 2019-148 (Aug. 8, 2019), *available at* https://www.sec.gov/news/press-release/2019-148.

[2]*See* SEC Proposed Rule Rel No. 33-10668 (Aug. 8, 2019), *available at* https://www.sec.gov/rules/proposed/2019/33-10668.pdf.

[3]*See* SEC Press Rel. No. 2019-158 (Aug. 21, 2019), *available at* https://www.sec.gov/news/press-release/2019-158.

[4]*See* SEC Press Rel. No. 2019-160 (Aug. 23, 2019), *available at* https://www.sec.gov/news/press-release/2019-160.

FROM THE EDITORS

Release the Lawyers! Two Lawsuits Set to Challenge SEC's Reg Best Interest Rule

On September 9, attorneys general from seven states and the District of Columbia brought suit against the Securities and Exchange Commission for its passage of Regulation Best Interest ("Reg BI"), which was adopted in June.

The suit claims that Reg BI "increases confusion about the standards of conduct that apply when investors receive recommendations and advice from broker-dealers or investment advisers." More importantly—at least to the viability of the suit—is that the new regulation "makes it easier for brokers to market themselves as trusted advisors . . . and contradicts Congress's express direction."

That last part—the expressed direction laid out by Congress in the Dodd-Frank Act as to how the SEC was to raise advice standards—and what that statute actually means is at the heart of this case. Some investor advocates think it's a slam-dunk. "They have a good argument," Barbara Roper, director of investor protection at the Consumer Federation of America, told *Investment News*. "The SEC has chosen to ignore that clear statement of congressional interest."

The SEC had mulled over Reg BI in some form for almost a decade, and the rule as adopted set differing standards for how broker-dealers can act when recommending securities to their retail customers versus how investment advisors are required to act.

Under Reg BI, broker-dealers are not required to act as *fiduciaries*, the standard that is imposed on investment advisers, but instead can "draw on key principles underlying fiduciary obligations." While it is not immediately clear what that means, the SEC argues that the new standard is a high one and that what is important is that both brokers and advisers are required to focus on their customer or client's best interest. Critics have argued that the standards are not the same, in that a true fiduciary standard requires that the fiduciary give absolute primacy to the interests of the customer and may not have conflicting interests.

Not surprisingly, many investor advocates were outraged at the passage of Reg BI and what it may mean for investor protection down the road. And now, the lawyers are coming!

Led by New York Attorney General Letitia James, the AGs of California, Connecticut, Delaware, Maine, New Mexico, Oregon, and the District of Columbia filed the suit. "With this rule, the SEC is choosing Wall Street over Main Street," James said in a statement announcing the lawsuit. "Instead of adopting the investor protections of Dodd-Frank, this watered-down rule puts brokers first. The SEC is now promulgating a rule that fails to address the confusion felt by consumers and fails to remedy the conflicting advice that motivated Congress to act in the first place."

Just one day after the seven-state lawsuit was filed, a similar suit—filed XY Planning Network, a coalition of fee-only financial planners, and Ford Financial Solutions—also argued the SEC was not following the intent of Congress. The suit also claimed that Reg BI leaves investment advisors at a distinct disadvantage because investors will have more difficulty differentiating the differing standards between investment advisors and broker-dealers.

With the SEC expected to file a response to the suits within weeks of their initial filing, the story was still developing as this issue of *Wall Street Lawyer* went to press. Indeed, many observers think the battle will rage beyond the SEC's deadline for Reg BI implementation of June 30, 2020.

—John F. Olson & Gregg Wirth

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