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LIU V. SEC: SUPREME COURT CABINS SEC DISGORGEMENT REMEDY

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If the measure of a ***good*** compromise is whether it leaves both sides equally dissatisfied, as the old adage goes, then the Supreme Court's recent ruling in *Liu v. Securities and Exchange Commission* may be considered a ***great*** compromise.[1] In *Liu*, the Supreme Court vacated the lower court's judgment containing a disgorgement order, but at the same time rejected petitioners' principal claim that the Securities and Exchange Commission ("SEC") has no statutory authority to seek disgorgement. Rather, the Court made clear that the SEC is permitted to seek disgorgement as an equitable remedy in federal court enforcement actions. However, the Court also cabined the SEC's disgorgement remedy in a number of significant ways, including narrowing it only to net profits (deducting "legitimate expenses"); clarifying that the remedy should be imposed only "for the benefit" of victim-investors, not the general public; and limiting the SEC's ability to seek disgorgement on a joint-and-several basis against codefendants. The Supreme Court's ruling thus delivers only a partial—likely unsatisfying—win for each side, leaving lower courts to wade through the quagmire of how to implement disgorgement in light of the Court's general guidance in *Liu*.

Background of the Litigation

The journey to *Liu* started years ago, with challenges to the SEC's authority to file suit outside the five-year statute of limitations period in 28 U.S.C.A. § 2462. In the Supreme Court's unanimous 2013 decision in *Gabelli v. S.E.C.*, the Court held that a claim by the SEC for civil penalties "accrues" for statute of limitations purposes when the wrongful conduct occurs, not when the alleged fraud is first discovered, as the SEC had argued.[2] The Court made clear that the SEC is unlike other civil plaintiffs given it "seeks a different kind of relief," such as penalties that "go beyond compensation, [and] are intended to punish, and label defendants wrongdoers."[3] The Court, however, noted in a footnote that its ruling did not address the SEC's requests for injunctive relief and disgorgement.[4]

Naturally, the Supreme Court next addressed the statute of limitations for disgorgement actions. In *Kokesh v. S.E.C.*, decided in 2017, a

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unanimous Supreme Court held that a "claim[] for disgorgement imposed as a sanction for violating a federal securities law" is a "penalty" subject to the same five-year period of limitations considered in *Gabelli*.[5] The Supreme Court reasoned that because disgorgement is sought "to remedy harm to the public at large," "imposed for punitive purposes," and often "is not compensatory" to victims, it is a penalty that is subject to the same five-year statute of limitations.[6] The Court again noted in a critical footnote that the ruling did not opine "on whether courts possess authority to order disgorgement in SEC enforcement proceedings," effectively inviting a challenge to the SEC's authority.[7]

With that footnote, enter petitioners Charles Liu and his wife, Xin (Lisa) Wang. Liu and Wang were sued and ultimately found liable by a District Court in California of investor fraud in connection with their fraudulent solicitation of $27 million from foreign investors under the EB-5 Immigrant Investor Program. Liu had pledged to invest the bulk of the contributions into the construction of a cancer-treatment center. In reality, Liu spent nearly $20 million of investor money on marketing expenses and salaries, and diverted a sizable portion to personal accounts and to a company under Wang's control. The district court ordered disgorgement equal to the full amount raised by petitioners, less only the relatively minimal amount retained in the corporate accounts dedicated to the cancer-treatment project.[8] Petitioners appealed, among other things, the scope of the lower court's disgorgement order, and the Ninth Circuit affirmed.[9]

The Supreme Court's *Liu* Ruling

In a near-unanimous 8-1 ruling authored by Justice Sonia Sotomayor, the Supreme Court vacated the judgment and disgorgement order in the case as inconsistent with equitable principles of disgorgement, discussed below. To that extent, Liu was victorious. But so was the SEC, because the Supreme Court granted the agency clear authority to seek disgorgement. Under the Securities Exchange Act of 1934, the SEC is permitted to seek both civil penalties and "any equitable relief that maybe appropriate or necessary for the benefit of investors."[10] Recognizing that "equity practice long authorized courts to strip wrongdoers of their ill-gotten gains," the Court concluded that the SEC's statutory authorization to seek equitable remedies encompasses the disgorgement remedy.[11] In so holding, the Court rejected petitioners' arguments that, under *Kokesh*, disgorgement is necessarily a penalty outside the contours of equitable relief, despite acknowledging that the disgorgement ordered in *Kokesh* "seemed to exceed the bounds of traditional equitable principles."[12] The Court also rejected petitioners' argument that disgorgement was only available in cases

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involving a breach of trust or when Congress had expressly provided for such relief.[13] Thus, the majority declined to circumscribe the SEC's authority to seek disgorgement or to limit its application as a matter of law only to certain types of cases.

But the SEC did not emerge completely victorious. While permitting disgorgement as an equitable remedy, the Court nonetheless criticized the practice of seeking disgorgement in many instances that are "in considerable tension with equity practices."[14] The Court held that because the disgorgement remedy is "restricted . . . to an individual wrongdoer's net profits to be awarded for victims,"[15] it must be narrowed in three important ways.

First, a disgorgement award must be "for victims."[16] The Court criticized the practice of "not always return-[ing] the entirety of disgorgement proceeds to investors, instead depositing a portion of its collections in a fund in the Treasury."[17] The Court thus held that disgorgement cannot be used merely to "depriv[e] a wrongdoer of ill-gotten gains," and must instead be for the benefit of the victim investors.[18] The Court, however, declined to address the SEC's practice of depositing disgorgement funds with the Treasury where "it is infeasible to distribute the collected funds to investors," since the lower court had not ordered disgorgement funds to be directed to the Treasury.[19]

Second, a disgorgement award should be limited by defendant and not ordered against "multiple wrongdoers under a joint-and-several liability theory," absent a showing that co-defendants were "engaged in concerted wrongdoing."[20] While the petitioners in *Liu* are married and had not rebutted evidence of each spouse's involvement in the fraud scheme, the Court emphasized that the SEC's practice of seeking "liability on a wrongdoer for benefits that accrue to his affiliates" risks "transform-[ing] any equitable . . . remedy into a penalty" that exceeds the SEC's authority.[21]

Finally, and significantly, disgorgement must be limited to net profits, and the "courts must deduct legitimate expenses before ordering disgorgement."[22] While courts may deny "inequitable deductions" where, for example, " 'the entire profit of a business or undertaking' results from the wrongdoing," a court must first actually assess those expenses to ascertain whether they "have value independent of fueling a fraudulent scheme."[23]

Justice Thomas dissented on the basis that "disgorgement is not a traditional equitable remedy."[24] Tracing the lineage of the disgorgement remedy, Justice Thomas found that the term "disgorgement" did not appear in published cases or legal dictionaries until the 20th century, long after the nation's founding, and that it was the SEC's own actions that ushered in the term's acceptance. He also warned that the majority ruling "threatens great mischief" if its disgorgement principles do not apply equally to SEC administrative proceedings, and cautioned that the "both courts and the SEC will continue to have license to expand their own [disgorgement] power."[25] Accordingly, he would have found that the SEC lacked authority to seek disgorgement under all circumstances.

Practical Implications

The three limitations identified by the Supreme Court in *Liu* may well have significant implications on a wide array of enforcement actions brought by the SEC, as well as the forum in which the SEC chooses to bring them. For example, because the holding of *Liu* is at this point limited to civil actions, the SEC may increasingly push to bring more enforcement actions "in-house" to its administrative tribunals (which *Liu* does not address), particularly in cases where no victims can be readily identified. Any such shift may have profound consequences to litigants, since the SEC's administrative proceedings deprive a litigant of the right to a jury trial, are litigated before an administrative law judge paid by the SEC, and lack basic procedural safeguards such as broad access to discovery. It is also possible that the SEC may shift its investigative and enforcement priorities in favor of cases with identifiable investor-victims, such as Ponzi schemes and other investment adviser frauds, and away from those without easily identifiable victims, as in Foreign Corrupt Practices Act ("FCPA") and insider trading cases. That said, in cases without identifiable victims,

the SEC will contend that disgorged funds may be deposited with the Treasury on the basis that the Treasury fund benefits investors or victims of fraud generally. In insider trading cases, in particular, the SEC may also have difficulty holding a tipper liable for a remote tippee's unlawful profits as it has historically attempted to do given the Supreme Court's suggestion that this practice is "at odds" with equitable principles.[26]

Given the potentially broad limitations on disgorgement in *Liu*, it is possible that Congress may eventually step in to provide a legislative remedy. Even before the *Liu* ruling, Congress had proposed bipartisan legislation that would have statutorily conferred disgorgement authority on the agency.[27] These legislative "fixes" may be easily modified to grant the SEC the broad disgorgement authority it prefers.

Until Congress steps in or the courts further clarify the reach of *Liu*, the SEC's ability to effectively use the disgorgement remedy as a club against wrongdoers is impacted by the *Liu* ruling. As an illustration, over the last five years, the SEC has obtained disgorgement orders totaling more than $14.5 billion, which has accounted for more than 70% of all total monetary remedies obtained by the SEC.[28] Undoubtedly, the Supreme Court's ruling in *Liu* will impact the SEC's enforcement program, but only time—and likely years of additional litigation—will spell out the full implications of the decision. Until then, the only sure thing is that the Supreme Court's ruling has left both sides dissatisfied victors.

ENDNOTES:

[1]*Liu v. Securities and Exchange Commission*, 140 S. Ct. 1936 (2020).

[2]See generally *Gabelli v. S.E.C.*, 568 U.S. 442, 133 S. Ct. 1216, 185 L. Ed. 2d 297, Fed. Sec. L. Rep. (CCH) P 97299 (2013).

[3]*Gabelli*, at 451-52.

[4]*Gabelli*, at 447 n.1 (specifying that because the District Court found the SEC's other requests timely, "those issues are not before us").

[5]*Kokesh v. S.E.C.*, 137 S. Ct. 1635, 1639, 198 L. Ed. 2d 86, Fed. Sec. L. Rep. (CCH) P 99733 (2017).

[6]*Kokesh*, at 1643-44.

[7]*Kokesh*, at 1642 n.3.

[8]*Securities and Exchange Commission v. Liu*, 262 F. Supp. 3d 957, 975-76 (C.D. Cal. 2017), aff'd, 754 Fed. Appx. 505, Fed. Sec. L. Rep. (CCH) P 100295 (9th Cir. 2018), cert. granted, 140 S. Ct. 451, 205 L. Ed. 2d 265 (2019) and vacated and remanded, 140 S. Ct. 1936 (2020).

[9]*Securities and Exchange Commission v. Liu*, 754 Fed. Appx. 505, 509, Fed. Sec. L. Rep. (CCH) P 100295 (9th Cir. 2018), cert. granted, 140 S. Ct. 451, 205 L. Ed. 2d 265 (2019) and vacated and remanded, 140 S. Ct. 1936 (2020).

[10]15 U.S.C.A. § 78u(d)(5).

[11]*Liu*, at 6.

[12]*Liu*, at 12-13.

[13]*Liu*, at 8-9.

[14]*Liu*, at 12.

[15]*Liu*, at 6.

[16] *Liu*, at 6.

[17] *Liu*, at 14.

[18] *Liu*, at 16.

[19] *Liu*, at 16-17.

[20] *Liu*, at 9-10, 18.

[21] *Liu*, at 17-18.

[22] *Liu*, at 19.

[23] *Liu*, at 19.

[24] *Liu*, at 1 (Thomas, J. dissenting).

[25] *Liu*, at 6-7 (Thomas, J. dissenting).

[26] *Liu*, at 17.

[27] The Securities Fraud and Investor Compensation Act, S. 799, 116th Cong. (2019); Investor Protection and *capital* Markets Fairness Act, H.R. 4344, 116th Cong. (2019).

[28] SEC, Division of Enforcement, 2019 Annual Report 16 (Nov. 6, 2019), https://www.sec.gov/files/enforcement-annual-report-2019.pdf.

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UPSTREAM LIABILITY FOR PRIVATE EQUITY FUNDS

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In times of economic distress, creditors start to look for non-traditional sources of payment. Private equity owners represent a rich target for creditors of portfolio companies.

While liability under traditional common-law alter-ego or veil-piercing theories is not commonly assessed against funds, there are numerous other sources of potential liability, principally the plethora of federal and state statutes regulating broad aspects of any portfolio company operations.

This is a multi-part article examining this type of risk in the context of three major federal statutes and their accompanying regulations: the WARN Act, the False Claims Act, and ERISA.

These statutes generally approach upstream liability from the perspective of corporate conglomerates. The animating principle is to ensure corporate parents can't hide behind thinly-capitalized subsidiaries and so, in an effort to elevate substance over form, the statutes provide a means to conflate a "controlling" corporate parent with a "controlled" subsidiary.

This approach doesn't square neatly with the alternative "fund—portfolio company" ownership structure. Private equity funds are generally organized as limited partnerships, and their governance is itself nuanced, with a general partner which outsources its investment management function to an affiliated investment advisor. And certain elements of the private equity business model that blur the distinction between investor and business, or put pressure on the distinction, exacerbate the problem. These elements include:

- Holdco-Opco structures, where Holdco lacks assets other than the stock of Opco;
- Substantial financial leverage;
- Management advisory agreements with management companies affiliated with the sponsor (the same entity that also serves as investment advisor to the fund);
- Intensive balance sheet management, often outsourced in part to the sponsor;
- Aggressive, owner-driven business strategies oriented to maximize value for a three to five year exit; and
- A hands-on governance approach.

Private equity funds are at bottom investment vehicles, not corporate parents in a General Electric-type conglomerate. But at the same time private equity investors are actively involved in managing their businesses. The level of involvement has, if anything, grown since the 2008 financial crisis, as sponsors have learned that superior returns can no longer be achieved through the use of financial leverage alone; rather the underlying businesses must be made to perform better. Though the specifics of "how this looks" can vary from sponsor to sponsor and company to company, the look is very different from that of a passive financial investor in publicly-traded equity securities. And the level of involvement usually becomes even more intensive where a portfolio company is financially troubled.

Liability Under the WARN Act

The federal Worker Adjustment and Retraining Notification Act the (the "WARN Act") often comes into play in times of economic distress. The WARN Act requires advance notice of large layoffs and awards damages where the required notice is not given. Not surprisingly, plaintiffs often aggressively seek an entity with assets more liquid than what the failed company has to offer.

The question of when and where to upstream WARN Act liability is confused, both in terms of the underlying

legal theory and the way legal theory is applied to facts in cases. To start with the legal analysis, the National Labor Relations Board has long used one approach, an "integrated enterprise" analysis, in the context of labor relations for determining when two entities constitute a "single employer." This analysis is used in cases under the Labor Management Relations Act, the Age Discrimination Act and the Fair Labor Standards Act, among other things, and the Department of Labor has adopted the analysis for the Family Medical Leave Act. The DOL has, however, issued an alternative set of regulations under the WARN Act with a different test for assessing what the DOL terms "single enterprise liability" under the WARN Act.

Pearson v. Component Technology Corp.[1] is a Third Circuit decision that rationalizes the various legal theories and provides a comprehensive approach to single employer liability. While the case involved the liability of a third party lender, it has been followed by a number of subsequent decisions looking at private equity owner[2] liability. *Pearson* determined that the proper test for upstream liability was, as laid out in the DOL's WARN Act regulations, based on the presence of five factors in the relationship between two entities:

- Common ownership;
- Common directors and/or officers;
- De facto exercise of control;
- Unity of personnel policies emanating from a common source; and
- Dependency of operations.

The first two factors are often present in the private equity setting, whereas the last two are not—a private equity owner does not typically expect uniformity of personnel policies across its portfolio companies, nor is there a dependency of operations between the owner fund and the company (or other portfolio companies). So in many WARN Act decisions the analysis focuses on the "de facto exercise of control" as the critical factor.

Generally speaking, these cases expose the tension between, on the one hand, an investor's "monitoring" its portfolio company's activities and, on the other hand, "taking control" of activity, particularly where the investor makes the decision that gives rise to the WARN liability, *i.e.*, ordering the shutdown. A leading and often-cited decision addressing this topic is *In re Jevic Holding Corp*.[3] The *Jevic* case involved Sun Capital. Referring to the "exercise of control," the court stated:

> The case law with respect to this factor is clear. The Court must consider "whether the parent has specifically directed the allegedly illegal employment practice that forms the basis for the litigation." *Pearson*, 247 F.3d at 491; *see also In re APA Transp. Corp. Consol. Litig.*, 541 F.3d 233, 245 (3d Cir. 2008) ("The core of this factor is whether one company 'was the decision-maker responsible for the employment practice giving rise to the litigation.' ") (citation omitted). This factor is "not intended to support liability based on a parent's exercise of control pursuant to the ordinary incidents of stock ownership." *Pearson*, 247 F.3d at 503.

The court concluded that there was no evidence that Sun Capital directed Jevic to shut down, and it rejected the plaintiffs' argument that Sun Capital should be liable for WARN damages because its decision to withhold further funding caused the shutdown.

> The Debtors retained the ultimate responsibility for keeping the company alive and therefore, Sun Cap did not incur WARN Act liability by refusing to make an additional investment. *Pearson,* 247 F.3d at 505. It is undisputed that the Debtors made the decision to shut down the company. The WARN notice was signed by the Debtors, not Sun Cap, and it is not alleged that Sun Cap played a direct role in the employees' termination. . . . Sun Cap's decision to cut off funding was not a "de facto exercise of control" over the Debtors' decision to close its doors.

The approach of *Pearson* and its progeny—limiting the question of control to whether the specific employment practice was directed by the parent, rather than examining control from a broader perspective—is in a sense reassuring to business owners. That being said, the way the underlying legal principles are applied to specific facts in *Jevic* and in many of these cases is curious. That is, *Jevic* is similar to many of the WARN Act decisions in taking a somewhat un-nuanced approach to the question of fund-owner liability. *Pearson* states that the

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"exercise of control" element is not intended to impose liability based upon the "ordinary incidents of stock ownership," but there is a lot of white space around what is "ordinary" and what it means to "direct" a decision to shut down a company.

In *Richards v. Advanced Accessory Systems, LLC*,[4] sponsor Castle Harlan avoided WARN liability in a case decided with reasoning similar to *Jevic*:

> Pursuant to a Management Agreement with [the portfolio company, AAS], Castle Harlan provided "business and organizational strategy, financial and investment management, advisory and merchant and investment banking services." Castle Harlan received management fees from AAS for these services. Castle Harlan was not, however, involved with the day-to-day operation of AAS. Specifically, Castle Harlan (1) played no role in meeting with customers or in seeking new or additional business, and (2) provided no administrative, human resources, or purchasing services, and did not have a role in the preparation of AAS personnel policies.

Concluding that "Castle Harlan's management of AAS was limited to ensuring its financial success and played no part in the day-today operations" of the portfolio company, the court found no WARN liability on the part of the private equity sponsor. (There was no discussion of how to square the presence of a management agreement with Castle Harlan with the court's statement that Castle Harlan provided no administrative services.)

Similarly, in *Cleary v. American Capital, Ltd.*,[5] American Capital was not faulted for the aggressive acts of its appointed directors attempting to save its portfolio company:

> [T]he actions undertaken by American Capital, however aggressive, were consistent with those of (an ultimately unsuccessful) attempt to protect its investment. These include proposing and assisting the recruitment of "new management," and the ferreting out of an accurate and complete understanding of the company books . . . While a WARN Act plaintiff should not be held to the nearly impossible burden of demonstrating a complete merger of identities between the defunct employer and its former equity owner, at a minimum a plaintiff must establish control by the latter over the "the allegedly illegal employment practice that forms the basis for the litigation." *Pearson,* 247 F.3d at 491. Plaintiffs offer no material evidence that the decision of [portfolio companies] NewStarcom and Constar to terminate all employees and file for bankruptcy was made by American Capital, nor any plausible reason why American Capital, as an unsecured creditor, would have thought it in the interest of its shareholders to do so.

Contrasting the lack of direct activity in the cases described above, a New Jersey appellate court (applying the *Pearson*-approved five factor DOL test to the New Jersey version of the WARN law) assessed the alleged activities of a fund sponsored by Lone Star Funds in *DeRosa v. Accredited Home Lenders, Inc.,*[6] an appeal taken from a lower court's grant of summary judgment in favor of the Lone Star fund.

Before the court was Accredited Home Lenders, Inc., a failed sub-prime mortgage lender that was in 2007 purchased by a string of holding companies to become a portfolio company of Lone Star Fund V ("LSFV"), whose investments were managed by a related company called Hudson Advisors. LSFV, Hudson, and the holding company of Accredited were party to an asset advisory agreement. There was some testimony indicating that after Lone Star's purchase of Accredited, the portfolio's "senior managers were no longer 'calling the shots.' " The shutdown was sudden and it was announced in person, not by any executive of Accredited, but by Hudson's director of portfolio management, who at the time of announcing the shutdown held himself out as an employee of Lone Star. Reversing a lower court's summary judgment decision in favor of both Lone Star and Hudson, the court held with respect to the question of de facto control:

> As to this factor, the record reflects that after LSFV Accredited purchased Accredited Holding, Hudson, LSFV and Accredited Holding entered into an asset advisory agreement pursuant to which Hudson provided oversight and support services to Accredited. According to [Accredited division manager] Mohan, during this time period, Accredited's senior management lost day-to-day control of the business. Prushan, who was employed by Hudson, was involved in evaluating Accredited's business and in planning and implementing the shutdown of the office.

> Giving plaintiff all favorable inferences, the record reflects that LSFV, through Hudson, exercised control over Accredited and ordered the closure of the office. The trial court also recognized that this presented a factual dispute that was unresolvable on summary judgment.

In *In re Tweeter OPCO, LLC*,[7] things were worse for Schultze Asset Management, a family investment fund run by its patriarch, George Schultze. In a rare outcome, summary judgment was granted *against* the fund because of its involvement with its portfolio company, Tweeter.

> The Court finds that the Plaintiff has established *de facto* control by [Schultze Asset Management ("SAM")] of the Debtor's employment practice. The [Tweeter CEO] Granoff termination letter evidences SAM's control over the Debtor, especially the portion that states, "we felt we needed tighter control of Tweeter within our own organization." George Schultze repeatedly called for reductions in payroll to increase profits. Further, George Schultze ordered Kelerchian to terminate employees of the Debtor in 2007, demonstrating his control over the Debtor's employment practice. With SAM employees on the Debtor's board, SAM's inside counsel supervising their actions, and SAM employees directly involved with terminating employees of the Debtor, the Court finds that SAM's exercise of *de facto* control over the Debtor on the WARN Act issue was particularly egregious. *See Pearson,* 247 F.3d at 504 (concluding that if the *de facto* exercise of control is "particularly egregious," then liability is warranted).

If the legal analysis in the WARN Act cases is somewhat confused, there are some practical lessons for private equity sponsors. For one, try not to step into the day-to-day affairs of the portfolio company and especially do not direct from above that the portfolio fund is to lay off workers and/or shut down. These decisions are properly in the domain of the directors of the troubled company, even if they are appointed by the private equity sponsor. It is not uncommon for sponsors to appoint a third party consultant (sometimes recommended by lenders) as a "Chief Restructuring Officer" for a troubled company. This is a practice that is likely helpful to mitigate WARN Act risk to the fund and sponsor. On the other hand, occasionally fund sponsors appoint sponsor employees as officers of portfolio companies. Clearly this is not a good idea from a WARN Act liability perspective or from the perspective of upstream liability more generally. The cases counsel that to the greatest extent practicable, the governance structure should maintain a distinction between the sponsor and the management team operating the business day-to-day, with the fund acting appropriately in its role as owner and company management making ordinary course business decisions. The board of directors should serve as the sole interface between owner and management. Management arrangements or agreements are an obvious exception to this, and while this is not a particularly favorable element to the upstream liability risk equation, the cases do not seem to single out these arrangements as a foundation for liability.

ENDNOTES:

[1]*Pearson v. Component Technology Corp.*, 247 F.3d 471, 17 I.E.R. Cas. (BNA) 769, 143 Lab. Cas. (CCH) P 11005 (3d Cir. 2001).

[2]References to "private equity owners" in this article refer generally to the limited partnership investment funds that invest in portfolio companies and "sponsors" to the investment advisor and/or general partner affiliated with the limited partnership. Some of the upstream liability cases are not rigorous in the approach to the different entities in a fund/advisor structure and conflate sponsors, their personnel and the actual funds.

[3]*In re Jevic Holding Corp.*, 492 B.R. 416, 424, 57 Bankr. Ct. Dec. (CRR) 272, 38 I.E.R. Cas. (BNA) 1155 (Bankr. D. Del. 2013), aff'd, 526 B.R. 547, 39 I.E.R. Cas. (BNA) 304, 164 Lab. Cas. (CCH) P 10719 (D. Del. 2014), aff'd, 656 Fed. Appx. 617, 2016 I.E.R. Cas. (BNA) 241827 (3d Cir. 2016).

[4]*Richards v. Advanced Accessory Systems, LLC*, 31 I.E.R. Cas. (BNA) 1387, 2010 WL 3906958 (E.D. Mich. 2010).

[5]*Cleary v. American Capital, Ltd.*, 59 F. Supp. 3d 249, 258-59, 165 Lab. Cas. (CCH) P 10729 (D. Mass. 2014).

[6]*DeRosa v. Accredited Home Lenders, Inc.*, 420 N.J. Super. 438, 22 A.3d 27, 32 I.E.R. Cas. (BNA) 927 (App. Div. 2011).

[7]*In re Tweeter OPCO, LLC.*, 453 B.R. 534, 545, 55 Bankr. Ct. Dec. (CRR) 41 (Bankr. D. Del. 2011).

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MATERIALITY IN THE CONTEXT OF CODE OF ETHICS DISCLOSURES

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Although not mandated to do so, most publicly-held corporations have codes of ethics. The SEC requires companies to make certain disclosures regarding a code of ethics. This article addresses the extent to which these disclosures may expose the company to liability.

Anyone familiar with securities law recognizes that "[f]or the securities lawyer 'materiality' is the name of the game."[1] The somewhat amorphous concept of materiality determines when a misstatement or omission may result in liability for securities fraud. As is the case with any disclosures, the growth of environmental, social, and governance ("ESG") disclosures implicates materiality determinations.[2] As discussed below, materiality is very fact-specific and based on the perceptions of reasonable investors. Thus, by its nature, materiality as a yardstick for securities disclosures does not provide a bright line test. This can be especially problematic when drafting disclosures relating to corporate codes of ethics and instances of corporate misconduct.

As mentioned above, the "G" in ESG stands for governance and necessarily includes focus on disclosures relating to a company's code of ethics. This article addresses codes of ethics and materiality considerations. As discussed more fully below, there are two basic scenarios in which materiality issues can arise in connection with a company's code of ethics or conduct that contravenes a code of ethics. When disclosing the existence of a code of ethics, the company must be careful to avoid material misrepresentations. Second, in addition to the affirmative disclosures relating to a company's code of ethics, serious breaches of the code of ethics may create an obligation to disclose the improper conduct. The amorphous nature of materiality determinations creates special challenges in drafting code of ethics disclosures.

Most publicly-held corporations have a code of ethics or code of conduct which, as noted above, must be disclosed in SEC filings. The existence of such a code raises questions not only as to whether the code related disclosures are materially accurate but also as to when conduct that is inconsistent with the code is material and must be disclosed. In drafting SEC filings, lawyers must be mindful of the nuanced issues in framing code of ethics and related disclosures.

Seasoned securities lawyers understand that deciding what is material is more of an art than a science. At the margins, materiality determinations cannot be made with the precision normally desired in drafting business transactions generally and securities disclosures in particular. This article addresses some of the particular difficulties in making materiality determinations when dealing with the code of ethics disclosure requirements.

Sarbanes-Oxley Act Section 406[3] required the SEC to address corporate codes of ethics disclosures. In order to qualify as a "code of ethics," the code must include "written standards that are reasonably designed to deter wrongdoing."[4] Regulation S-K item 406 was the result.[5] Item 406 requires companies to disclose whether they have adopted a corporate "code of ethics" that covers the conduct of the company's principal executive and senior financial officers.[6] If the company has not adopted a code of ethics, the company must explain why it has not adopted one.[7] There, thus, is no mandate that a public company have a code of ethics.[8] However, even prior to the SEC's disclosure requirement, most publicly held companies had a code of ethics or a code of conduct.[9] Consequently, most publicly held companies disclose the existence of their code of ethics. Once the code of ethics is disclosed, questions arise as to whether there is contrary conduct that the company must disclose.

Over the years there have been a number of securities lawsuits filed claiming that the company's disclosures were materially misleading with respect to the company's

code of ethics. Usually these claims arise in connection with allegations of noncompliance with the adopted code of ethics and nondisclosure of that noncompliance. The outcome in these cases hinges on an analysis of whether nondisclosure of the deviation from the code of ethics is materially misleading. Forty-five years ago, former SEC Commissioner Al Sommer cautioned against an overly broad interpretation of materiality:

> Materiality is a concept that will bear virtually any burden; it can justify almost any disclosure; it can be expanded all but limitlessly. But we must constantly bear in mind that overloading it, unduly burdening it, excessively expanding it, may result in significant changes in the role of the Commission, the role of other enforcement agencies, and our ability to carry out our statutory duties.[10]

That caution still rings true today. An overly broad concept of materiality with respect to codes of ethics would in essence punish companies for adopting a code of ethics by exposing them to undue risk of liability.[11] This does not mean, however, omissions and misstatements relating to a company's compliance with its code of ethics can never violate the securities laws. As discussed below, there clearly can be situations in which poorly conceived discussions of ethics can be material. Navigating the materiality conundrum is thus a challenge in drafting disclosures relating to codes of ethics and related conduct.

By its very nature, materiality is a relatively amorphous concept that often creates a great deal of uncertainty in drafting SEC disclosures. The process of determining what is material lacks the certainty that most transactional lawyers would like to have as a partner in drafting SEC filings. Materiality depends on whether the plaintiff can establish "a substantial likelihood that a reasonable shareholder would consider it important."[12] The reality is that materiality determinations are nuanced and fact specific.[13]

Notwithstanding the apparent trend in the case law finding no liability, there are risks that the conduct in question and statements regarding codes of ethics or corporate conduct may rise to the level of materiality. With increasing pressure to strengthen ESG disclosures generally, it would not be surprising to find an increased focus on disclosures relating to codes of ethics. Long ago the SEC indicated that statements relating to management integrity are material.[14] Thus, to the extent the noncompliance with the code of ethics is a reflection of questionable integrity, omission of the actual conduct from the company's disclosures could be material.[15] Of course, it is a difficult line to draw between deviations from ethical conduct generally and situations that cast doubt on management integrity. Nevertheless, it is an important factor to consider in drafting code of ethics disclosure. Materiality is based on the "total mix" of publicly-available information.[16] As a result, there is always the possibility that if the alleged misconduct has received a good deal of publicity in the popular press and news media, the information is publicly available and this negates the claim that there was a material omission from SEC filings.

Investors have not generally been successful in bringing fraud claims based on a corporation's statements related to its code of ethics.[17] The difficulty in establishing materially misleading disclosures regarding codes of ethics is largely due to a corporation's code being viewed as aspirational rather than a statement as to the actual conduct of the company and its employees.[18] It is thus clear that not every violation of a company's code of ethics are material.[19] The choice of words used to discuss corporate codes can go a long way towards protecting the statements from a finding of materiality. As the Second Circuit explained:

> It is well-established that general statements about reputation, integrity, and compliance with ethical norms are inactionable puffery, meaning that they are too general to cause a reasonable investor to rely upon them. This is particularly true where . . . statements are explicitly aspirational, with qualifiers such as "aims to," "wants to," and "should."[20]

Even without such qualifying language, generalized statements about a company's commitment to ethical conduct are often considered aspirational and hence not materially misleading.[21] Although generalized statements are likely to be immaterial,

> This is not to say that statements about a company's reputation for integrity or ethical conduct can never give rise to

> a securities violation. Some statements, in context, may amount to more than "puffery" and may in some circumstances violate the securities laws: for example, a company's specific statements that emphasize its reputation for integrity or ethical conduct as central to its financial condition or that are clearly designed to distinguish the company from other specified companies in the same industry.[22]

Thus, general language will not necessarily preclude a finding of materiality when there are specific representations relating to the company's compliance efforts.[23] Similarly, linking compliance to positive corporate performance likely will lead to a finding of materiality.[24] Additionally, as noted above, generally presented ethics disclosures can lead to liability for material omissions regarding wrongful conduct that is inconsistent with the company's code of ethics. For example, if a corporation's statements about its code of ethics were held to be susceptible to a finding of material misstatements for failing to disclose the company's alleged participation in a bribery scheme.[25]

In addressing materiality regarding codes of ethics, courts have used the same analysis they use with respect to materiality generally. For example, statements regarding corporate codes are susceptible to being characterized as vague generalities and therefore not material.[26] Courts have also based immateriality findings by describing the statements as puffery[27] rather than material representations of fact. For example, lawsuits have been brought based on claims that omission of sexual harassment or misconduct were material in light of the company's code of ethics. Some have been dismissed[28] while others have survived the materiality threshold.[29] Some of the decisions seem inconsistent making it difficult to predict when the materiality threshold will be reached. For example, allegations of omission of a pervasive culture enabling sexual harassment was found immaterial in one case with the court describing the statements about the code as "quintessential puffery."[30] However, in another case, the court found similar allegations to be material.[31] This uncertainty poses a dilemma in drafting code of ethics disclosures. In yet another case specific denials of improper conduct were found to be material.[32] Thus, silence on alleged misconduct is likely to be less risky than a questionable denying of wrongdoing. However, to the extent that a corporate culture contrary to the code of ethics involves serious misconduct, that misconduct could result in the dismissal of the wrongdoers. If those wrongdoers are high profile, then nondisclosure of conduct that could lead to dismissal could well be a material omission.[33]

Omission of facts likely to impact a CEO's or other high profile manager's longevity with a company has been recognized as material in other contexts.[34] Thus, although less risky, silence could still result in a material omission. As discussed below, while there is no duty to disclose something absent a specific line-item disclosure requirement, silence can be actionable when it takes the form of an omission that renders statements made materially misleading.

Additional insight on the materiality of code of ethics requirements might be gleaned from the SEC's stance on shareholder proposals relating to codes of ethics. The SEC staff has opined that day-to-day business decisions may be more likely to be a legitimate matter of shareholder concern and hence not excludible from management's proxy statement,[35] especially when they relate to matters "over and beyond" legal compliance issues.[36] Again, the message is the same—the more specific the disclosures become, the more likely it is that they will be material.[37]

Challenges to a toxic corporate culture have not been limited to securities law. Paralleling the challenges under the securities laws, a recent tactic has been to challenge an alleged toxic corporate culture and rampant sexual harassment under state law. For example, in one recent filing, a shareholder sought a company's books and records relating to suspected widespread sexual harassment within the company.[38] If turned over to the requesting shareholder, the books and records might well provide sufficiently specific conduct that could form the basis of a securities law claim for material omissions of fact, in addition to any state law fiduciary duty claims that might exist.

In drafting codes of ethics and related disclosures,

lawyers need to be mindful of materiality considerations and ensure that the discussion relating to codes of ethics does not expose the company to undue litigation risk. Thus, in drafting disclosures relating to the company's code of ethics, care must be taken to minimize the potential for a court's characterizing a code of ethics as an implied representation that the code is a representation regarding the actual conduct taking place within the company. In addition, publicly-held companies and their lawyers should be mindful about material misconduct that may need to be disclosed in light of the code of ethics discussion.

ENDNOTES:

[1]Richard W. Jennings & Amp Harold Marsh, Jr., Securities Regulation: Cases And Materials 1023 (5th ed. 1982).

[2]*See, e.g.,* my earlier article, *Securities Law, Social Responsibility, and a Proposal for Improving ESG Disclosure*, 24 Wall. St. Law. 6 (Issue 5 May 2020).

[3]Sarbanes-Oxley Act of 2002, Pub. Law 107-204 (July 30, 2002) § 406, codified in 15 U.S.C.A. § 1764.

[4]Regulation S-K item 406, 17 C.F.R. § 229.406.

[5]Reg. S-K item 406.

[6]Reg. S-K item 406.

[7]Reg. S-K item 406.

[8]However, the disclosure requirements clearly provide a strong incentive, since companies that do not adopt a code of ethics will have to make that disclosure and will appear out of line with the companies that have adopted such a code.

[9]As of 1998, 90% of Fortune 500 companies were said to have adopted a code of ethics. *See* Myrna Wulfson*, Rules of the Game: Do Corporate Codes of Ethics Work*, 20 Rev. Bus. 12 (1998). As of 2013, 95% of Fortune 100 companies were identified as having a code of ethics.

[10]A.A. Sommer, *The Slippery Slope of Materiality,* https://www.sec.gov/news/speech/1975/120875sommer.pdf (Dec. 8, 1975).

[11]*See, e.g., Ferris v. Wynn Resorts Limited*, Fed. Sec. L. Rep. (CCH) P 100829, 2020 WL 2748309 at * 14 (D. Nev. 2020) ((“'it simply cannot be that every time a violation of that code [of conduct] occurs, a company is liable under federal law for having chosen to adopt the code at all, particularly when the adoption of such a code is effectively mandatory.' ”), quoting *Andropolis v. Red Robin Gourmet Burgers, Inc.*, 505 F. Supp. 2d 662, 686 (D. Colo. 2007).

[12]*TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S. Ct. 2126, 48 L. Ed. 2d 757, Fed. Sec. L. Rep. (CCH) P 95615 (1976). Accord *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 131 S. Ct. 1309, 179 L. Ed. 2d 398, Fed. Sec. L. Rep. (CCH) P 96249, 62 A.L.R. Fed. 2d 737 (2011); *Basic Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988).

[13]*See generally* 3 Thomas Lee Hazen, Treatise On The Law Of Securities Regulation §§ 12:60-12:74 (7th ed. 2016) (detailing the cases on materiality generally).

[14]*In the Matter of Franchard Corp.*, 42 S.E.C. 163, 172, Release No. 33, 4710, Release No. 4710, 1964 WL 67454 (S.E.C. Release No. 1964) (management integrity is “always a material factor”).

[15]*See, e.g., Securities and Exchange Commission v. Joseph Schlitz Brewing Co.*, 452 F. Supp. 824, Fed. Sec. L. Rep. (CCH) P 96464 (E.D. Wis. 1978) (nondisclosure of kickback scheme was material regardless of de minimis quantitative significance because inter alia, it reflected on the lack of management integrity); *In the Matter of Franchard Corp.*, 423 S.E.C. 163 (1964) (CEO's cash withdrawals should be judged not by the quantitative amount but rather the extent to which they reflect negatively on management integrity which rendered the disclosures materially misleading);. *See also, e.g., In re Unisys Corp. Securities Litigation*, Fed. Sec. L. Rep. (CCH) P 91218, 2000 WL 1367951 (E.D. Pa. 2000) (misstatements relating to less than 1% of income could be material), relying on *In re Westinghouse Securities Litigation*, 90 F.3d 696, 714-715, Fed. Sec. L. Rep. (CCH) P 99271, 35 Fed. R. Serv. 3d 1449 (3d Cir. 1996) (misstatement of loan reserves amounting to.54% of total income could have been material but was not, since it was not demonstrated that this was otherwise important to investors).

[16]*Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 131 S. Ct. 1309, 179 L. Ed. 2d 398, Fed. Sec. L. Rep. (CCH) P 96249, 62 A.L.R. Fed. 2d 737 (2011) (“ 'a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available' ”), quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978, 985, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988) and *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S. Ct. 2126, 48 L. Ed. 2d 757, Fed. Sec. L. Rep. (CCH) P 95615 (1976).

[17]*See, e.g., Singh v. Cigna Corporation*, 918 F.3d 57,

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Fed. Sec. L. Rep. (CCH) P 100368 (2d Cir. 2019) (statements in corporation's code of ethics expressing its commitment to regulatory compliance were puffery and could not support securities fraud claims); *In re Sinclair Broadcast Group, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) P 100742, 2020 WL 571724 (D. Md. 2020) ("statements in corporate codes of conduct can be characterized as inactionable 'puffery': statements of a company's ideals rather than representations of past or present fact"); *Barilli v. Sky Solar Holdings, Ltd.*, 389 F. Supp. 3d 232, Fed. Sec. L. Rep. (CCH) P 100420 (S.D. N.Y. 2019) (statements in prospectus regarding company's code of ethics were mere puffery and thus not actionable); *Cement & Concrete Workers District Council Pension Fund v. Hewlett Packard Company*, 964 F. Supp. 2d 1128, Fed. Sec. L. Rep. (CCH) P 97600 (N.D. Cal. 2013) (CEO's misconduct and firing did not render company's code of ethics which he violated materially misleading).

[18]*See, e.g., Retail Wholesale & Department Store Union Local 338 Retirement Fund v. Hewlett-Packard Co.*, 845 F.3d 1268, Fed. Sec. L. Rep. (CCH) P 99608 (9th Cir. 2017) (alleged sexual misconduct of officer and alleged violation of ethics code were not material; the court noted that the company's statements promoting the company's code of ethics "were transparently aspirational" and "did not reasonably suggest that there would be no violations of [the code] by the CEO or anyone else"); *In re TransDigm Group, Inc. Securities Litigation*, 440 F. Supp. 3d 740, Fed. Sec. L. Rep. (CCH) P 100750 (N.D. Ohio 2020) (" 'a code of conduct is not a guarantee that a corporation will adhere to everything set forth in its code of conduct' and, instead, is simply a 'declaration of corporate aspirations' "), quoting *Bondali v. YumA Brands, Inc.*, 620 Fed. Appx. 483, Fed. Sec. L. Rep. (CCH) P 98603 (6th Cir. 2015); *In re Braskem S.A. Securities Litigation*, 246 F. Supp. 3d 731, Fed. Sec. L. Rep. (CCH) P 99676 (S.D. N.Y. 2017) (code of ethics was aspirational and did not imply that it was complied with).

[19]*Andropolis v. Red Robin Gourmet Burgers, Inc.*, 505 F. Supp. 2d 662, 686 (D. Colo. 2007) ("it simply cannot be that every time a violation of that code [of conduct] occurs, a company is liable under federal law for having chosen to adopt the code at all, particularly when the adoption of such a code is effectively mandatory."). Accord *Ferris v. Wynn Resorts Limited*, Fed. Sec. L. Rep. (CCH) P 100829, 2020 WL 2748309 at * 14 (D. Nev. 2020).

[20]*City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG*, 752 F.3d 173, 185, Fed. Sec. L. Rep. (CCH) P 97950 (2d Cir. 2014). Accord *In re Vale S.A. Securities Litigation*, 2020 WL 2610979 at * 10 (E.D. N.Y. 2020).

[21]*See, e.g., Kushner v. Beverly Enterprises, Inc.*, 317 F.3d 820, 831, Fed. Sec. L. Rep. (CCH) P 92259 (8th Cir. 2003) ("Absent a clear allegation that the defendants knew of the scheme and its illegal nature at the time they stated the belief that the company was in compliance with the law, there is nothing further to disclose."); *Das v. Rio Tinto PLC*, 332 F. Supp. 3d 786, 806-807, Fed. Sec. L. Rep. (CCH) P 100255 (S.D. N.Y. 2018) (statements about code of ethics were immaterial); *Employees Retirement System of City of Providence v. Embraer S.A.*, 2018 WL 1725574 at * 8 (S.D. N.Y. 2018) (conduct inconsistent with code of ethics was not material since code was aspirational); *S.E.C. v. Kovzan*, 807 F. Supp. 2d 1024, 1042, Fed. Sec. L. Rep. (CCH) P 96506 (D. Kan. 2011) ("NIC stated only that it had adopted a code, that all employees were required to follow it, and that any waivers would be disclosed on the company's website. NIC did not suggest thereby that there had been no violations or waivers"); *Galati v. Commerce Bancorp, Inc.*, Fed. Sec. L. Rep. (CCH) P 93610, 2005 WL 3797764 at * 5 (D.N.J. 2005), aff'd, 220 Fed. Appx. 97, Fed. Sec. L. Rep. (CCH) P 94186 (3d Cir. 2007) (claims of illegal conduct were too speculative to be material).

[22]*Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85, 98, Fed. Sec. L. Rep. (CCH) P 99048 (2d Cir. 2016), cert. dismissed, 138 S. Ct. 2670, 201 L. Ed. 2d 1047 (2018) (but holding that the statements in question were too generalized to be material).

[23]*See, e.g., In re Vale S.A. Securities Litigation*, 2020 WL 2610979 (E.D. N.Y. 2020) (while general aspirations of sustainability were aspirational, the materiality threshold was satisfied by company's specific recommendations regarding steps being taken).

[24]*See, e.g., In re Vale S.A. Securities Litigation*, 2020 WL 2610979 (E.D. N.Y. 2020)(" 'While certain statements, "viewed in isolation, may be mere puffery," when the statements are "made repeatedly in an effort to reassure the investing public" about matters particularly important to the company and investors, those statements may become material to investors.' ") *In re BHP Billiton Limited Securities Litigation*, 276 F. Supp. 3d 65, 79 (S.D. N.Y. 2017) (quoting *In re Petrobras Securities Litigation*, 116 F. Supp. 3d 368, 381, Fed. Sec. L. Rep. (CCH) P 98587 (S.D. N.Y. 2015)).

[25]*In re Grupo Televisa Securities Litigation*, 368 F. Supp. 3d 711 (S.D. N.Y. 2019) (sufficiently pleading materiality omissions from statements about code of ethics in light of nondisclosure of company's participation in bribery scheme). *But see, e.g., DoubleLine Capital LP v. Odebrecht Finance, Ltd.*, 323 F. Supp. 3d 393, 441-42, Fed. Sec. L. Rep. (CCH) P 100237 (S.D. N.Y. 2018) (in the absence express statement, a corporation has no affirmative duty to disclose "uncharged, unadjudicated wrongdoing;" similarly, the company corporation disclose illegal internal policies, or violations of the corpo-

ration's internal codes of conduct and legal policies. A duty to disclose uncharged criminal conduct may arise when failure to disclose such conduct would make other statements materially misleading); *Menaldi v. Och-Ziff Capital Management Group LLC*, 164 F. Supp. 3d 568, 581-82, Fed. Sec. L. Rep. (CCH) P 99025 (S.D. N.Y. 2016) (no duty to disclose uncharged wrongdoing but upholding complaint for other misrepresentations).

[26]*See, e.g., Rex and Roberta Ling Living Trust u/a December 6, 1990 v. B Communications Ltd.*, 346 F. Supp. 3d 389, Fed. Sec. L. Rep. (CCH) P 100278 (S.D. N.Y. 2018) (statements in company's code of ethics were "vague platitudes" and thus not materially misleading).

[27]*Carvelli v. Ocwen Financial Corporation*, 934 F.3d 1307, Fed. Sec. L. Rep. (CCH) P 100539 (11th Cir. 2019) (statements regarding progress it was making toward state regulatory compliance were puffery); *Barilli v. Sky Solar Holdings, Ltd.*, 389 F. Supp. 3d 232, Fed. Sec. L. Rep. (CCH) P 100420 (S.D. N.Y. 2019) (statements in prospectus regarding company's code of ethics were mere puffery); *Lopez v. Ctpartners Executive Search Inc.*, 173 F. Supp. 3d 12, 28-29, Fed. Sec. L. Rep. (CCH) P 99049 (S.D. N.Y. 2016) (statements about code of ethics and ethical corporate culture were immaterial puffery).

[28]*See, e.g., Retail Wholesale & Department Store Union Local 338 Retirement Fund v. Hewlett-Packard Co.*, 845 F.3d 1268, Fed. Sec. L. Rep. (CCH) P 99608 (9th Cir. 2017) (finding omissions were not material).

[29]*In re Signet Jewelers Limited Securities Litigation*, 389 F. Supp. 3d 221 (S.D. N.Y. 2019) (defendant's motion to dismiss denied). The court noted: "While generalized, open-ended or aspirational statements do not give rise to securities fraud (as mere puffery), statements contained in a code of conduct are actionable where they are directly at odds with the conduct alleged in a complaint," *Signet* at 226, quoting *In re Moody's Corp. Securities Litigation*, 599 F. Supp. 2d 493, 508 (S.D. N.Y. 2009), opinion corrected on denial of reconsideration, 2nd Cir. 13-3754612 F. Supp. 2d 397 (S.D. N.Y. 2009).

[30]*Oklahoma Law Enforcement Retirement System v. Papa John's International, Inc.*, Fed. Sec. L. Rep. (CCH) P 100764, 2020 WL 1243808 (S.D. N.Y. 2020) (statements regarding the company's code of ethics were not materially misleading notwithstanding alleged corporate culture enabling sexual harassment).

[31]*In re Signet Jewelers Limited Securities Litigation*, 389 F. Supp. 3d 221 (S.D. N.Y. 2019) (statements in company's code of conduct were not mere puffery with regard to company's alleged pervasive culture of sexual harassment; defendant's motion to dismiss denied).

[32]*Construction Laborers Pension Trust for Southern California v. CBS Corporation*, 433 F. Supp. 3d 515, Fed. Sec. L. Rep. (CCH) P 100730 (S.D. N.Y. 2020) (although company had no duty to disclose CEO's alleged misconduct as part of its MD&A or risk factors discussion, CEO's statements about the #MeToo movement and specific denials of sexual misconduct were materially misleading in light of his alleged misconduct).

[33]*Cf. In the Matter of Franchard Corp.*, 423 S.E.C. 163 (1964) (CEO's pledges of his own stock was material since foreclosure on those pledges could lead to a change in the company's management).

[34]For example, the SEC investigated whether Apple's delayed disclosure of Steve Jobs' cancer violated the securities laws. *See, e.g.,* Staci D. Kramer, *Apple Being Investigated by SEC Over Way Steve Jobs' Health Handled? It Should Be,* CBS News, https://www.cbsnews.com/news/apple-being-investigated-by-sec-over-way-jobs-health-handled-it-should-be/ (Jan. 21, 2009). *See also, e.g.,* Susan S. Muck, David A. Bell & Michael S. Dicke, *Best Practices for Disclosing Executive Health Issues,* Harv. L. Sch. Forum On corp. Governance, https://corpgov.law.harvard.edu/2020/01/08/best-practices-for-disclosing-executive-health-issues/ (Jan. 8, 2020).

[35]Certain Fidelity Funds, 2008 WL 223122 (SEC No Action Letter Jan. 22, 2008) (management could not rely on Rule 14a-8(i)(7) nor on Rule 14a-8(i)(3) to exclude the following proposal: "In order to ensure that Fidelity is an ethically managed company that respects the spirit of international law and is a responsible member of society, shareholders request that the Fund's Board institute oversight procedures to screen out investments in companies that, in the judgment of the Board, substantially contribute to genocide, patterns of extraordinary and egregious violations of human rights, or crimes against humanity"). *But see, e.g.*, *Verizon Communications, Inc.*, 2010 WL 5169382 (SEC No Action Letter Jan. 10, 2011) ("proposals that concern general adherence to ethical business practices are generally excludable under rule 14a-8(i)(7)").

[36]*See, e.g., Bank of America Corp.*, 2008 WL 591024 (SEC No Action Letter Feb. 29, 2008) (management could not rely on Rule 14a-8(i)(7) to exclude a proposal to amend the bylaws to establish a board committee that will review the implications of company policies, above and beyond matters of legal compliance, for the human rights of individuals in the United States and worldwide). *Occidental Petroleum Corp.*, 2009 WL 851495 (SEC No Action Letter Feb. 26, 2009) (management could not rely on Rule 14a-8(i)(7) to exclude a proposal asking the board of directors to conduct a review of the policies and procedures that the company uses to assess the laws and regulations of host countries in the company's overseas operations, with respect to their adequacy to protect the environment and the health and human rights of indigenous populations, and report the results of the review to the company's shareholders).

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[37]*See, e.g., In re Banco Bradesco S.A. Securities Litigation*, 277 F. Supp. 3d 600, 659, Fed. Sec. L. Rep. (CCH) P 99897 (S.D. N.Y. 2017) (statements in code of ethics may have been aspirational but "the context in which the statements about Bradesco's Code of Ethical Conduct and its other anti-corruption statements were made persuades the Court that they are not to be treated as immaterial as a matter of law at this stage of the litigation").

[38]*See* Jeff Montgomery, *Investor Sues Victoria's Secret Parent Over "Toxic Culture,"* Law 360, https://www.law360.com/delaware/articles/1280141/investor-sues-victoria-s-secret-parent-over-toxic-culture-?nl_pk=d8e8e675-b3ae-488e-b86a-15d04b0b8d13&utm_source=newsletter&utm_medium=email&utm_campaign=delaware (June 4, 2020) (seeking corporate records relating to "alleged 'toxic culture' of sexual harassment and intimidation").

MEANS OF DEALING WITH FINRA ENFORCEMENT ACTIONS

On June 17, 2020, ***Wall Street Lawyer*** *spoke with Andrew St. Laurent, a partner at Harris St. Laurent LLP in New York, on the topic of how counsel could better prepare when dealing with FINRA enforcement actions.*

Wall Street Lawyer*: To begin with, are some lawyers still relatively unaware of what separates a FINRA enforcement case from, say, a typical civil or criminal case?*

Andrew St. Laurent: One thing to note is that FINRA actions are still relatively uncommon. As per their website, there were 26 published decisions in 2019: that tracks roughly to 26 cases that went to hearings in that year.

By contrast, if we're just talking about the New York criminal courts alone, in an average year, you'd expect anywhere from 150 to 200 jury trials in Manhattan in one year. And that's still just one county in one state in the U.S. Whereas FINRA is covering the whole country.

In addition to that, in 2019 there were 472 acceptance, waiver, and consent ("AWC") letters. AWC is the type of plea bargaining in FINRA [these are letters in response to a FINRA complaint in which the accused accepts a finding of violation, consents to sanctions, and waives the right to a hearing/appeal.]

So a FINRA litigation case that goes all the way to hearing is still relatively uncommon for many lawyers that are otherwise active in securities litigation practices. They tend to have far more cases dealing with the SEC, the CFTC, and state regulators than they do with FINRA. It's in part because FINRA has a narrow jurisdiction but also that there are a lot of incentives for respondents to settle, as opposed to having contested hearings, as you can see from the fact that there are so many more dispositions by AWC than through a hearing.

Also, there's a difference in that FINRA applies nationwide, from retail broker-dealers in Ohio to registered reps in South Dakota—they're all subject to the same basic [issues] that FINRA addresses: unauthorized trading, outside business activities, misleading or false filings, people failing to report bankruptcies and so forth. It's the same thing in Georgia as it is in a financial center like New York and Chicago. So, there are going to be a number of general practitioners who may be unfamiliar but will have to try to do their best to defend a FINRA case.

WSL*: What are some of the key differences between a FINRA case and a typical civil or criminal case?*

St. Laurent: In a way, FINRA is neither fish nor fowl: its cases have civil penalties but they often can seem more like criminal cases, in terms of how cases are developed and how information given to the defense except that you don't have the right to invoke the Fifth Amendment. That's one of the biggest differences from a criminal case.

FINRA enforcement has much better access to documents and to witnesses, by virtue of its role as a regulator. All FINRA members, all licensed broker-dealers, have to live with FINRA day-in day-out, and so complying with a FINRA request can be an everyday occurrence. You'll do it for all kinds of reasons. And yet none of that information is available to the respondent until relatively late

in the proceedings. One big reason for that is Rule 8210 requests. FINRA can serve it for any reason or for really no stated reason, and can compel a person in their jurisdiction—for example, any registered rep, or anyone who used to be a registered rep for two years afterward—and ask them questions under oath, without having indicated what they're looking into. In a way, this makes the respondent commit to a theory of the case before they really know anything about the case. That's a huge structural advantage for FINRA.

Also, [in a FINRA case] those who decide the case also work for FINRA. While the Department of Enforcement is separate from the Office of Hearing Officers, the people who decide the cases, they all work under the big umbrella that is FINRA. So the department of enforcement has a lot of credibility coming out of the gate with the hearing panelists and hearing officers that will preside over them. They have a lot of experience and it's a lot of the same types of cases over and over. And FINRA really does try hard to resolve cases pre-hearing, if there's a basis to resolve them. You can meet with the line attorney or with the director a number of times before charges are brought, in an effort to steer the ship to somewhere that your respondent can safely land.

So in short, the defense is on its backfoot, informationally and reputationally, before they even walk in the front door.

In that, it's like a criminal case. But on the other hand, you have to deal with 8210 requests directed at your client, generally at the very beginning of the case, that your client has to answer or risk being barred for not answering. For a criminal defense practitioner, coping with those 8210 requests could be surprising or offputting.

WSL: *And FINRA cases typically move much faster than your average civil or criminal case?*

St. Laurent: There's a long period of investigation in many cases. But once the wheels are in motion for enforcement proceedings, things move pretty quickly. I'd say the typical timeframe, from the time of complaint, from the serving of the Wells notice [a notification that the regulator intends to recommend that enforcement proceedings be commenced], is about 30 to 60 days. Then the time from the complaint being filed to the hearing is generally six months, for a case with reasonable number of documents. Then you have the hearing, maybe some post-hearing submissions, and then a ruling, which usually takes about 60 days from the last post-hearing submission.

So it's often nine months in total from when a respondent gets the official notice that charges are being considered to a ruling on the merits. That's quite fast. A criminal case, even in a "rocket docket," takes up to a year. And a criminal case in many other districts will go for a couple of years.

WSL*: What are some of the best strategies a defense could use, given these circumstances?*

St. Laurent: The first thing is to have reasonable expectations as to what is going to happen if, say, you're terminated from a broker-dealer for any reason that approaches a violation of internal policy, or if you were terminated pursuant to an investigation. In those cases it's virtually certain FINRA will investigate that. So if you are likely to be a respondent, you want to get an early start. You can't be in the position where you're thinking "this is going to go away." Making an investment of time and resources could be incredibly important. FINRA has a two-year window and they may give a Wells notice on day 722. They want to spend as much time before that with their documents. So that's a period during which a respondent can be out gathering their own documents, looking through their own personal email as opposed to waiting for the blow to come.

Another thing to consider is collateral litigation. People have contracts which may have a provision that provided different benefits, depending on whether a termination from employment it's by cause or not. By litigating that question a person may be able to take depositions and that may be material to a FINRA proceeding. It's something to think about. You can bring a defamation action for a statement, if it fits all of the ele-

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ments of common law. These are some things that a respondent can consider, in terms of litigation, which may put the respondent in a better position to defend themselves.

WSL: *Do you have the sense that FINRA is getting more aggressive in terms of pursuing cases in the past year or so?*

St. Laurent: Yes, we seem to be in a period of greater emphasis on enforcement, where FINRA has become more aggressive and is more likely to press for more serious sanctions, bigger penalties, more months of suspension. That is not new, they're settling into their role as a regulatory enforcer. There can be a lot of overlap between FINRA and the SEC, and within the broker/dealer context FINRA is sometimes the more likely one to investigate an issue.

NEW RULES ON USE AND FORGIVENESS OF PPP LOANS

By Gail Weinstein, Michael T. Gershberg, William J. Breslin, and Suzanne deVries Decker

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On June 5, 2020, the "Paycheck Protection Program Flexibility Act of 2020"[1] was enacted. The Flexibility Act modifies the CARES Act provisions relating to the Paycheck Protection Program ("PPP"), particularly by affording borrowers additional flexibility with respect to eligibility for the forgiveness of PPP loans.

According to the U.S. Treasury Department, as of June 6, 2020, about $130 billion of funds remain available for PPP loans. Reportedly, demand for PPP loans has declined dramatically since the inception of the program due to concerns by some businesses that, because they have remained closed in accordance with governmental shut-down orders, they would not be able to comply with the requirements for use and forgiveness of the loans. It remains to be seen whether the additional flexibility provided by the Flexibility Act will be sufficient to spark a renewal in demand for PPP loans.

The changes effected by the Flexibility Act apply to PPP loans issued before or after enactment of the Flexibility Act (except as otherwise described below). The key changes are as follows.

Forgiveness of PPP Loans

Reduction of the requirement that borrowers use 75% of the loan proceeds for payroll costs. Prior to enactment of the Flexibility Act, under the CARES Act, to be eligible for forgiveness of a PPP loan, the borrower was required to use at least 75% of the loan proceeds for payroll purposes and could use only up to 25% for the other permitted purposes (rent, mortgage interest, and utilities). In addition, regulations issued by the SBA under the CARES Act have required that, irrespective of forgiveness, a PPP borrower has to use at least 75% of the proceeds for payroll costs and can use only up to 25% for the other permitted purposes. Now, under the Flexibility Act, to be eligible for loan forgiveness, the borrower must use at least 60% (rather than 75%) of the proceeds for payroll costs and can use up to 40% (rather than 25%) for the other permitted purposes. In addition, a statement issued by the SBA on June 8, 2020 indicates that the SBA will issue new regulations to provide that, irrespective of forgiveness, a borrower must use at least 60% of the proceeds on payroll costs and only up to 40% on the other permitted purposes. The June 8 statement also clarifies that if a borrower uses less than 60% of the proceeds for payroll costs, partial forgiveness of the loan will still be available.

Extension of the eight-week period for use of the loan proceeds. Prior to enactment of the Flexibility Act, to be eligible for forgiveness of a PPP loan, the borrower had to use the proceeds within eight weeks following the date of disbursement of the loan. Under the Flexibility

Act, the eight-week period has been extended to the earlier of (i) 24 weeks after the date of disbursement of the loan or (ii) December 31, 2020. (The Flexibility Act permits borrowers who obtained loans before enactment of the Flexibility Act to elect to continue with the existing eight-week period.) We note that the lead sponsors of the Flexibility Act have clarified that the change of the definition of "covered period" to extend it to (at the latest) December 31, 2020 (i) is intended to allow borrowers who received PPP loans before June 30, 2020 to continue to make expenditures for allowable purposes after June 30, but (ii) does not affect the existing deadline of June 30, 2020 for PPP loan applications to be approved.

Extension of the June 30 date, and the addition of "safe harbors," for rehiring employees and restoring wages. Under the CARES Act, the amount of forgiveness for which a PPP loan borrower is eligible is determined based on (i) the ratio of (a) the average number of monthly full-time equivalent employees ("FTEs") during the covered period divided by (b) the number of average monthly FTEs during one of two reference periods elected by the borrower, and (ii) reductions in the cash compensation of employees by more than 25% between February 15 and April 26, 2020. However, reductions in FTEs are not counted to the extent they were implemented between February 15 and April 26, 2020 and then were restored by June 30, 2020; and reductions in compensation are disregarded if the previous compensation level was restored by June 30, 2020. The Flexibility Act changes the June 30 deadline for restoration to December 31, 2020. In addition, under previous guidance, the SBA had clarified that borrowers could exclude from the count of terminated FTEs any employees who had refused good faith offers by the borrower for rehiring. Now, under the Flexibility Act, a borrower also can exclude terminated employees from the FTE count to the extent that the borrower can document that (i) it was unable to rehire individuals who were employees on February 15, 2020 (and was unable to hire "similarly qualified" individuals for unfilled positions by December 31, 2020); or (ii) it was unable to return to the same level of business activity it had on February 15, 2020, due to compliance with requirements established or guidance issued, between March 1, 2020 and December 31, 2020, by the U.S. Health and Human Services ("HHS"), the Centers for Disease Control and Prevention ("CDC"), or the Occupational Safety and Health Administration (OSHA), relating to "the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to COVID-19."

Other Terms: Maturity Date; Payment Deferral; Payroll Taxes Deferral

Extension of the maturity date. Under the Flexibility Act, PPP loans issued after June 5, 2020 will have a minimum maturity term of five years. PPP loans issued previously have a maturity term of two years; and, with respect to these loans, the Flexibility Act states that nothing in the Flexibility Act, the CARES Act or the PPP program shall be construed to prevent the borrower and the lender from mutually agreeing to modify the maturity terms of the loan.

Extension of the deferral period for payment. Prior to enactment of the Flexibility Act, the borrower's payment of principal, interest and fees under a PPP loan was deferred for six months from the date of disbursement of the loan. The Flexibility Act extends the deferral period to the date on which the SBA remits the borrower's loan forgiveness amount to the lender. If a borrower fails to apply for forgiveness within 10 months after the last day of the forgiveness covered period (*i.e.*, 10 months after the earlier of (a) 24 weeks after disbursement of the loan or (b) December 31, 2020), then the borrower must start making payments of principal, interest and fees on the loan, beginning on the date that is "not earlier than the date that is 10 months after last day of such covered period" (unless the lender agrees to a longer deferment).

Eligibility for the deferral of payroll taxes. The CARES Act permits employers to defer the payment of payroll taxes for the portion of the 2020 calendar year beginning with the date of enactment of the CARES Act. (The payment is deferred to December 31, 2021 for 50% of the taxes and to December 31, 2022 for the other 50%.) Prior to enactment of the Flexibility Act, a PPP

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borrower could not obtain both forgiveness of a PPP loan and the payroll tax deferral permitted under the CARES Act (and so would have to decide which of the two would be more beneficial and forego the other). The Flexibility Act provides that an employer whose PPP loan is forgiven is now eligible for the CARES Act payroll tax deferral as well.

Open Issues

Operational issues. It is unclear how, for the approximately 4.5 million PPP loans issued prior to June 5, 2020, lenders will notify the borrowers of, and will process, the changes mandated by the Flexibility Act. Borrowers should keep in mind that not all lenders have used the same form of documentation for PPP loans. In addition, many lenders expressly incorporated in their loan agreements the original terms as set forth in the CARES Act, and these agreements will not reflect the new terms promulgated under the Flexibility Act. Thus, these agreements may need to be amended to reflect the retroactive changes made by the Flexibility Act (as well as any changes agreed by the lender and the borrower as permitted by the Flexibility Act). A borrower with an existing PPP loan should review the terms of the loan documents and be proactive in requesting that the lender make appropriate amendments.

"Covered period." First, as discussed above, the forgiveness amount will be reduced based on a reduction in the average FTEs over the "covered period" of the loan and the Flexibility Act has extended the covered period. It is not clear how the forgiveness amount will be reduced if a borrower who has laid off employees but still has proceeds to be used now lays off additional employees during the expanded 24-week covered period. Second, as discussed above, the Flexibility Act permits existing borrowers to elect to retain the eight-week "covered period" that commences from the date of disbursement of the loan. Presumably (although it is not expressly stated), the current guidance remains in effect which permits borrowers with biweekly or more frequent pay periods to elect to begin the covered period on the first pay period commencing after the date of disbursement of the loan.

Safe harbors for calculating the forgiveness amount. As discussed, the Flexibility Act permits existing PPP borrowers to elect to retain the original eight-week "covered period" for the calculation of FTEs to determine the forgiveness amount. However, it is not clear whether borrowers who elect to retain the eight-week covered period can also continue to use June 30, 2020 as the date for determination of whether the new safe harbors apply or they must use the new December 31, 2020 date. If the December 31 date applies in all cases, this may delay when applications for forgiveness based on the safe harbors can be submitted.

Timing for forgiveness. The CARES Act interim final rule issued April 3, 2020 states that the PPP lender must make a determination on forgiveness within 60 days of receiving the borrower's application for forgiveness. It is not clear, however, whether a PPP loan is thereby officially forgiven, or whether additional steps (such as approval by the SBA) are required and the loan is officially forgiven only at the time the SBA remits the forgiven amount to the lender. In addition, the government has announced that all PPP loans over $2 million are subject to audit at the time forgiveness is requested—and it is unclear how that process will work and whether the audit will have to be concluded before the loan is forgiven.

Maturity date. As noted, all new PPP loans, to the extent not forgiven, must have a term of at least five years. The CARES Act establishes a maximum interest rate of 4% for PPP loans; and the SBA's PPP regulations set a rate of 1% for all PPP loans. It remains to be seen whether, absent a change to permit higher interest rates, lenders will be willing to originate new loans with a five-year maturity or to lengthen the maturity of existing loans.

ENDNOTES:

[1] https://www.congress.gov/116/bills/hr7010/BILLS-116hr7010enr.pdf.

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MODERNIZING U.S. EQUITY MARKET STRUCTURE

By Jay Clayton and Brett Redfearn

Jay Clayton is the Chairman of the Securities and Exchange Commission, and Brett Redfearn is Director of the Division of Trading and Markets at the SEC. This is adapted and excerpted from remarks that the two gave in Washington D.C. on June 22, 2020.

Jay Clayton: Today marks the third consecutive year that Director Redfearn and I have addressed equity market structure. Our remarks have focused on three areas needing close attention—improving the market for thinly-traded securities, combatting retail fraud, and addressing concerns about the quality and cost of market data.[1] Here I am very pleased that we have meaningful progress to report as well as some key initiatives we are working to complete. . .

Principles Guiding Our Equity Market Structure Agenda

When discussing equity market structure, I have made it a habit to begin by emphasizing the principles that guide our approach. These principles are clearly articulated in my prior speeches, so I will break that habit and not repeat them here, but they are in my posted remarks.[2] I am pleased to announce that work pursuant to one key principle—coordinating and communicating with other regulators—is being furthered through a new Memorandum of Understanding signed between the SEC and the DOJ Antitrust Division. Our agencies each have their respective areas of responsibility—the DOJ is responsible for antitrust policy and enforcement, and the SEC is responsible for securities market function, structure and enforcement—but there are significant commonalities of facts and expertise as both agencies work to promote competitive market conditions. I believe that close coordination and communication between us—and the experts on our career staff—contribute to a well-functioning regulatory environment . . .

I would also like to reiterate that the power of choice and competition is crucial and formative to our securities markets. Another of my key principles dictates that access to material information can empower investors and energize the competitive forces that benefit markets broadly. It is through this lens that I consider our equity market structure and the essential question of whether access to markets and material information about those markets is fair and reasonable. As I have previously noted, it has long been recognized that market prices can function as "public goods."[3] Efficiently providing this function—through a combination of regulation and market forces—can be challenging to achieve in practice, however, particularly in a complex, high-speed environment such as trading.

It is only fair to note that this discussion of improving efficiency and function should be viewed against the backdrop of substantial progress over the past two decades, particularly from the perspective of trading costs. Today, retail investors pay substantially less for execution than they did ten and twenty years ago and, in our largest stocks and related derivatives, liquidity is strong. We also should remember that liquidity is not free—market makers and other professional traders participate actively because they expect to turn a profit. Here, I would be remiss if I did not mention the recent court case vacating the Commission's transaction fee pilot. While I think that the Commission should continue to focus on and pursue data-driven analysis, rulemaking and policy, I accept the decision of the D.C. Circuit and appreciate the guidance it provides. I expect the Commission will move forward with its efforts to improve and modernize our National Market System following that guidance. To me, the decision served to emphasize our need to have real data from exchanges, ATSs, and other market participants to facilitate oversight and analysis of new and existing rules. The court has said that the Commission cannot set up this kind of controlled environment, and so I expect we will continue to work in the real environment to make sure we have the data and other information we need.[4]

Modernization of Equity Market Structure

The initiatives we will discuss today are intended generally to improve our ever-changing securities markets. We began this journey in 2018 by identifying three mar-

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ket structure areas in need of modernization. For each of these areas, we have followed the same transparent and rigorous path forward: the staff held roundtables that sought out a wide range of viewpoints and then developed specific initiatives to advance for public comment. I am pleased to say that the public comments we have received reflect a breadth and depth of expertise and insight on what can be highly complex and technical market structure issues.

Improving the Market for Thinly-Traded Securities

On area we have targeted for progress is improving the quality of our market for thinly traded securities. Today, Regulation NMS mandates a single market structure and regulatory framework for all exchange-listed stocks, regardless of their different characteristics. At the 2018 Roundtable on Market Structure for Thinly-Traded Securities, several participants were critical of this one-sized-fits-all approach and highlighted the particular challenges facing companies and investors in this segment of the market.[5]

Following the Roundtable, in October 2019, the Commission published its Statement on Market Structure Innovation for Thinly-Traded Securities inviting market participants to submit innovative proposals designed to improve the secondary market for thinly traded securities, including, in connection with such proposals, requests to suspend or terminate unlisted trading privileges, known as UTP.[6]

I want to make a few points. First, the SEC's effort to improve secondary market trading for thinly traded securities is but one of several initiatives that the SEC has pursued to advance the interests of small and mid-size companies.[7] And second, there is no magic solution that will suddenly produce deep pools of liquidity for thinly traded securities. But the fact that the task may be difficult is no reason not to take it head on. We must think creatively about how best to proceed and without letting the perfect be the enemy of the significantly better.

Brett Redfearn: At the same time that the Commission issued its Statement, the Division of Trading and Markets published a Background Paper on the Market Structure for Thinly-Traded Securities that presents some of the characteristics and trading challenges of this segment of the market.[8] Companies with stocks in this segment of the market face some difficult challenges not faced by companies with actively traded stocks. The Staff Background Paper references economic research indicating that improving secondary market liquidity can have real benefits for companies. I believe there are serious questions, however, about whether the current market structure that works relatively well for very active stocks is optimal for thinly-traded securities.

The Commission's Statement mentions a number of potential innovations that may be worth considering. These include providing incentives to market makers to assume heightened obligations with regard to thinly traded securities, implementing periodic intraday auctions as a means to concentrate liquidity, and introducing non-automated markets to facilitate trade negotiation and incentivize market maker participation. I am pleased that a range of commenters have responded to the Statement and submitted views and potential approaches, including an application by an exchange for an exemption from UTP, to improve the market structure for thinly traded securities that the staff is studying closely.[9]

Going forward, proposals should fully lay out the elements of the proposal and the rationale for whatever relief is requested from current rules. To the extent proposals involve proposed rule changes, these would provide an opportunity for the public to comment on the specifics of an exchange's proposed market structure innovations, and would not become effective unless the Commission approved the proposed rule change.

Combatting Retail Fraud

Clayton: We have taken a comprehensive approach to combatting retail fraud and protecting the interests of our long-term Main Street investors. Among other things, we have focused on empowering investors by providing them with the information and tools they need to identify and avoid fraudsters—in other words, to help prevent harm rather than seeking to remedy harm after-the-fact.

At the 2018 Roundtable on Combatting Retail Fraud, one of the main topics of discussion concerned investors' lack of sufficient information about companies with securities that are not listed on a national securities exchange, or OTC securities.[10] Over decades, many of these types of securities have served as vehicles for fraud and manipulation, and just over the last several years, the Commission has brought hundreds of enforcement actions involving OTC securities or their issuers.[11] This has gone on too long.

What adds to my concern is that securities that trade in the OTC market are primarily owned by and marketed to retail investors. Just as material information and transparency serve as the foundation for our federal securities law framework, the information that is available to these investors trading OTC securities is a vital element of our regulatory scheme to protect retail investors. Under Rule 15c2-11, broker-dealers serve as key "gatekeepers" in helping to prevent fraud and manipulation in OTC securities. The Rule sets out requirements that broker-dealers must meet before they can publish quotations in an OTC security. These broker-dealer quotations are a primary mechanism for facilitating the secondary market trading of OTC securities.

At the Roundtable, panelists were concerned that Rule 15c2-11 was outdated and needed to be modernized in several respects.[12] Well, the Rule was last amended in 1991. Clearly, much has changed in the financial markets since then, and the Rule needed to be closely reviewed. Today, among other things, the internet provides an incredibly cost-effective and efficient mechanism to collect and make information publicly available.

One of the major concerns about the Rule is its "piggyback" exception. Under the piggyback exception, the current Rule allows quoting in an OTC security to continue in perpetuity, even when there is no or limited current, publicly available information about the issuer and even when the issuer no longer functions or even exists. Experience tells us, unfortunately, that these information deficiencies can be fertile ground for fraud.

I am pleased that last September, the Commission proposed amendments to Rule 15c2-11.[13] The amendments are designed to increase the availability of issuer information and modernize the rules governing quotations for OTC securities. I agree that sunlight is the best disinfectant, and in particular, I believe that we owe it to our Main Street investors to ensure that a minimum level of current information is publicly available if securities are to be quoted by brokers. Investors can and should be able to continue to trade OTC securities, but they should be able to do so with reasonably current—and not stale—information. . .

Modernizing NMS Market Data and Access

The third roundtable initiative relates to market data and access. Market data is the fundamental source of transparency and price discovery for the secondary equity markets. And by market data, I mean real-time information concerning the prices at which securities can be traded and the prices of trades that already have been executed. Collecting, consolidating, and disseminating this data have formed the heart of the National Market System ever since Congress mandated its creation in 1975. In 2005, in Regulation NMS, the Commission emphasized that NMS market data enabled "investors of all types—large and small—[to] have access to a comprehensive, accurate, and reliable source of information for the prices of any NMS stock at any time during the trading day."[14]

Currently, we have (1) NMS market data that is disseminated by an exclusive processor, known as the SIP, which the exchanges govern jointly pursuant to three separate NMS plans; and (2) an array of proprietary data products that the exchanges sell to various market participants. NMS market data, generally speaking, informs the retail segment of the market as well as professional traders looking at screens and making investment decisions at speeds handicapped by the response times of the human brain. The proprietary data products generally are faster and provide richer and more detailed trading data than NMS market data. These products are also essential fuel for the trading systems used by electronic market makers and other firms with highly sophisticated technologies and trading strategies

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that find opportunities in microseconds—and increasingly nanoseconds.

Many panelists and commenters at the 2018 Roundtable on Market Data and Market Access expressed a strong belief that NMS market data was no longer adequate to meet the needs of many investors, both retail and institutional.[15] Their criticisms were wide-ranging and included concerns about the declining relative utility of the content of NMS market data as trading practices and regulations changed, as well as the measurably slower timeliness as technology evolved and trading speed increased. Various market participants stated that, given what they viewed as the shortcomings of NMS market data, they felt compelled to purchase proprietary depth of book data products.[16] Panelists and commenters also were concerned that deficiencies in the governance of NMS market data had contributed to the SIPs' comparatively slower evolution.

The SEC has emphasized that one of its "most important responsibilities is to preserve the integrity and affordability of" NMS market data.[17] Given the fundamental concerns raised at the Roundtable by a broad spectrum of investors and market participants, I asked the staff to develop recommendations for Commission initiatives to address these concerns. I am pleased that the Commission was able to move forward with three initiatives over the last year. These initiatives addressed (1) the process for review of NMS market data fee changes, (2) governance of the NMS market data plans, and (3) infrastructure for NMS market data. Once again, I will turn it over to Brett to discuss the details of these initiatives after emphasizing a few points.

First, Main Street investors require NMS market data, at a minimum, to participate in the U.S. equity markets. The CTA plan website, for example, reveals that 3.48 million non-professionals were monthly subscribers to data for NYSE-listed securities in the fourth quarter of 2019.[18] Many millions more use NMS market data on a "per-quote" basis.[19] These users, whether monthly or per-quote, generally are retail investors, obtaining data by requesting quotes from their brokers.

Second, I am pleased that the infrastructure proposal would introduce, for the first time, competitive forces into the model for processing and distributing NMS market data. Under the proposal, the current exclusive SIP model developed in the 1970s would be replaced by a model that (1) accommodates multiple competing consolidators, and (2) would allow firms to process, or "self-aggregate," NMS market data feeds, in a way that is similar and consistent with the way in which firms self-aggregate proprietary data feeds today. Significantly, the proposal would also create round lot tiers where lot size better reflects the prices of securities and the notional value of the posted quote. In today's markets, the average consumer is often not quoting or trading in 100-share round lots, and sometimes, in these circumstances, price improvement may be illusory.

And finally, while there are undoubtedly many issues to be addressed in terms of whether initiatives as proposed should be modified or improved, I do not believe that the status quo is acceptable. I anticipate that considering each of the three market data initiatives will be a high priority item on the SEC's equity market agenda for the remainder of the year.

Rescinding the Effective-on-Filing Procedure for NMS Plan Fee Changes

Redfearn: The first market data proposal was published last October and addresses the procedure for review and approval of NMS plan fee changes.[20] These fees currently are charged by the NMS plans for market data in NMS stocks and listed options, and they are substantial—the fees exceeded $500 million in 2017 and the NMS plans charge for their use by a broad spectrum of market participants.[21] These include millions of retail investors, institutional investors, professional traders, broker-dealers, and vendors.

Currently, however, Rule 608 of Regulation NMS provides an exception to the normal procedure for review and approval of NMS plan amendments. The exception allows fee changes to be immediately effective upon filing with the Commission, prior to an opportunity for public vetting and without Commission review or approval.

Under the proposal, the fee exception would be rescinded. Public notice and comment, in particular, is an integral aspect of the Commission's process for assessing important policy questions across many contexts. I anticipate the Commission soon will consider a staff recommendation on rescinding this exception.

Improving Governance of the NMS Plans for Equity Data

The second market data proposal was first published in January and addressed the governance structure of the three separate NMS plans for equity market data. The Commission proposed requiring the self-regulatory organizations, or SROs, that are participants in the three NMS plans to propose a new single plan to govern the arrangements for public dissemination of NMS market data.[22] After reviewing many thoughtful comments on the proposed order, the Commission issued a Final Order last month.[23]

The Final Order begins by describing some of the significant content and latency deficiencies of NMS market data that Chairman Clayton noted earlier. One fundamental problem stems from the inherent conflict of interest that exists for exchanges that offer competing proprietary data products at the same time as they are responsible for the governance and operations of NMS market data. Another is the limitation on voting participation in the NMS plans to SROs exclusively, which excludes all other stakeholders in NMS market data.

To address these concerns, the Final Order requires the SROs to submit a proposed new NMS plan that will make adjustments to the voting rights for exchange groups with multiple SROs and expand voting participation to key stakeholders with a diversity of views. The new plan also will require provisions to help manage the conflicts of interest of exchanges that offer proprietary data products that compete with NMS market data.

The Commission's order directed the SROs to submit a new plan within 90 days, which will be noticed for public comment before the Commission takes action. Until a new plan has been approved by the Commission, the current equity data plans will continue in effect. Both NASDAQ and NYSE have filed petitions for review of the Final Order in the D.C. Circuit.

Upgrading the Infrastructure of NMS Market Data and Access

The Commission's third market data initiative proposes meaningful changes to modernize the infrastructure for collecting, consolidating, and disseminating NMS market data.[24] The proposal is designed to update the content of the information with respect to quotations for and transactions in NMS stocks and to introduce a decentralized consolidation model for the collection, consolidation, and dissemination functions currently performed by the exclusive SIP.

The proposal would greatly expand the content of NMS market data in three ways: (1) lowering the round lot size to improve pre-trade transparency for many higher-priced securities, (2) including depth-of-book price levels beyond the best bid and offer, and (3) including information that facilitates participation in exchange auctions.

I want to focus first on the proposal to lower the round lot size for many higher-priced securities. Currently, the round lot size for nearly all NMS stocks is 100 shares, regardless of its price. This means, for example, that the best available quote for an NMS stock with a price of $10 must have a quoted dollar value of at least $1,000, while the best available quote for an NMS stock with a price of $500 must have a quoted dollar value of at least $50,000. Further, the quoted spreads currently visible in NMS market data for higher-priced stocks do not include significant quotation information of smaller lot sizes that is visible only in certain proprietary data feeds. NMS quotations are therefore less representative and significantly wider than they would be if smaller dollar-sized quotations were included.

As noted, exchange proprietary data feeds typically include all odd-lot quotes and thereby provide better and more thorough information than is available in the NMS market data feeds. For example, the proposal includes empirical analysis showing that, for stocks priced over $1000, the proposal to lower the round lot size could

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improve quoted spreads in NMS market data 92 percent of the time and narrow the width of such spreads by more than half.[25] Today, the many retail investors that use NMS market data cannot see the better prices available to those who can pay the much higher fees for exchange proprietary data. Furthermore, execution quality statistics, as provided under Rule 605, also only use the wider 100 share round lot quotations, which can affect the view of price improvement. Enhancing the quote information in NMS market data would be quite useful to retail investors in assessing the quality of executions obtained by their broker-dealers.

To this end, the proposal would establish five tiers of round-lot quotes. NMS stocks with prices of $50 or less would retain the 100-share round lot, while NMS stocks with prices higher than $50 would have four progressively lower tiers of round-lot sizes to maintain a relatively consistent dollar size for the inclusion of quotes in NMS market data, regardless of stock price. A key objective in formulating these tiers was achieving the right balance of, on the one hand, capturing additional liquidity to improve the usefulness of quote information in NMS market data and, on the other hand, avoiding unnecessary complexity with too many tiers.

The importance of achieving the right balance must not be overlooked, particularly from the standpoint of retail investors, who may not know that they may be receiving prices inferior to odd-lot quotes. An example may help illustrate this point. Today, the best-priced offer for a higher-priced stock in NMS market data may be 100 shares for $400.50, while the exchange proprietary data feeds may have a 20-share offer at $400.45. If a retail investor places a 20-share buy order and it is executed at $400.48, the executing venue is entitled to report that the retail investor received two cents for price improvement. This is true even though an odd-lot quote on the exchange proprietary data feeds was readily available at a price that was three cents better than the "price-improved" execution supposedly provided to the retail investor. Because the NMS market data does not show the true best-priced quote for her order, the retail investor is none the wiser that in fact she received a price that was three cents inferior than what was readily available in the market. In striking the right balance between data usefulness and complexity, we must not shortchange the information needs of retail investors.

Another aspect of the proposal is that if adopted as proposed it would *not* expand the scope of the trade-through rule, Rule 611 of Regulation NMS, to the new round-lot quotes. A "trade-through" is the execution of a trade at a price that is outside of the best displayed quoted price, which is protected by regulation. This is another area where a key objective is to strike the right balance. We are considering whether the highly prescriptive trade-through rule is necessary for these smaller quotations, or whether an approach that relies on competitive forces and the duty of best execution better strikes the right balance of protecting investors, particularly retail investors, without introducing unnecessary complexity and rigidity. As expected, many commenters have focused on the issue of order protection for the new round lots, and we are carefully considering all comments.

Beyond expanding and improving the content of NMS market data, a second major objective of the infrastructure proposal is to reduce its latency when compared to the exchange proprietary data feeds. The current operating model mandates an exclusive processor for NMS stocks in a centralized consolidation model, whereby data from multiple exchanges in different locations is sent to an exclusive processor in one location, aggregated, and then disseminated back to markets and market participants in multiple, often distant locations. This centralized model adds a significant amount of travel time between locations, which we refer to as geographic latency. The proposal would reduce this latency by allowing for a decentralized distribution model and introducing competition into the model for aggregating and disseminating NMS market data. The proposed model allows for exchange data to be sent directly to competing consolidators or self-aggregating firms in multiple locations to avoid this unnecessary added latency. For years, the private data market has utilized this form of direct data distribution due to its material latency benefits.

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A potential objection to a competing consolidator model is that it would mean losing the "single NBBO" under the current exclusive processor model. "NBBO" stands for "national best bid and offer." But, as the Commission explained in its proposal, the idea that there is only one NBBO does not reflect today's reality. Many market participants calculate their own NBBO from proprietary data feeds and these vary ever so slightly depending upon, for example, the exact location of the participant. The concern about the loss of a single NBBO that is exactly the same regardless of location simply does not acknowledge common practices and physical realities in our markets today. On these practices, I will share a few key points:

1. Because many trading firms do not consider NMS market data to be competitive, those firms often purchase proprietary data directly from exchanges. These firms also aggregate that data into an NBBO that is used for both trading and regulatory purposes. And, since these firms are often located in different data centers, they are also subject to the laws of physics.

2. On physics, there are unavoidable limitations due to the speed of light—and the speed of fiber optic cable. This means that, as long as users are not all in the exact same location—which they are not—information cannot reach all users at exactly the same time. As a result, the NBBO at one location will vary slightly from the NBBO at another location.

Today, hundreds of firms are located in different locations. Some buy NMS market data, some aggregate proprietary data. Some get their data over fiber. Some get their data over microwave towers. Anyhow, you get the point. There is no one NBBO in a world where markets are quoting and trading in nanoseconds.

The NMS rules recognize, as they must, this reality and allow market participants to trade based on information as it arrives. In the 2005 adopting release for Regulation NMS, for example, the Commission explicitly stated that a trading center's compliance with Rule 611 is based on when information arrives at that trading center.[26]

As noted, the proposed competing consolidator model would not change the fact that there are many NBBOs today. It would, however, introduce competitive forces to help ensure that NBBOs reflect a wider range of orders and are available to a broader range of market participants at lower latency than they are under today's monopoly model. This rule would better enable the vast array of competitive technologies that have been deployed in the proprietary data market also to be deployed in a competitive fashion in the market for NMS market data.

Helping to Ensure SRO Market Data and Connectivity Fees Comply with Exchange Act Standards

Clayton: The last topic we will discuss today is the SEC's role in ensuring that exchange fees for market data and connectivity comply with the Exchange Act. Under Section 19(b) of the Exchange Act, Congress charged the SEC with the responsibility to determine whether the fees charged by exchanges comply with statutory standards[27] including, as Brett will describe in greater detail, that fees be fair and reasonable and equitably allocated across users of an exchange's facilities.

As you may know, a recent judicial decision addressed the Commission's review of exchange fees and ended what had been a 14-year saga that has played out in the Commission and the courts. That is too long. I will try to give you the abridged version. It all began in 2006, when an exchange filed a rule change to impose a fee for its depth-of-book product. The Commission approved the fee change, applying a "market-based approach" to determine whether the fee was fair and reasonable under the Exchange Act. In 2010, market participants challenged the Commission's approval, and the D.C. Circuit vacated the Commission's order, finding that the administrative record did not sufficiently support the conclusion that competition would appropriately constrain the exchange's depth-of-book fees. In late 2018, after consolidating two exchanges' depth-of-book fee filings in response to challenges by market participants, the Commission found that the two exchanges had failed to demonstrate that competition appropriately constrained the exchanges' pricing of their fees. Separately, between the

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2010 D.C. Circuit decision and the 2018 Commission order, Congress enacted a new law under the Dodd-Frank Act that made exchanges' fee changes immediately effective upon filing. Following this procedural shift, market participants challenged an additional 400 fee changes. This month [June], the D.C. Circuit vacated the Commission's 2018 order.

But this time, the Court's decision narrowly focused on a procedural issue.[28] The Court held that generally applicable fees for market data charged by the exchanges—these are fees that are applicable to all market participants—could not be challenged by market participants in a particular type of administrative proceeding, known as a denial of access proceeding.

The court did not address a key substantive issue in the case, namely, the Commission's finding that two exchanges had failed to meet their burden of demonstrating that their fees for proprietary market data were constrained by competitive forces and therefore met Exchange Act standards.

So where does that leave us? One thing is crystal clear. In the absence of evidence demonstrating that competitive forces actually constrain the pricing of market data, the Commission has the obligation, under the Exchange Act, to suspend exchanges' fee filings unless it is established that the fee is reasonable on another basis, such as a reasonable cost basis. In other words, the exchange has the burden of demonstrating these competitive forces or an alternative basis for finding the fee fair and reasonable.

Many panelists and commenters at our Market Data Roundtable noted that proprietary exchange fees had risen significantly, did not believe that the exchange fees were constrained by competitive forces, and questioned whether the fees were set at levels consistent with Exchange Act requirements to be reasonable.[29] The DOJ's Antitrust Division, led by Mr. Delrahim, submitted a thoughtful comment letter on the infrastructure proposal.[30]

Clearly, given the diversity of views, the Commission has a compelling regulatory responsibility to analyze concerns about the fairness and reasonableness of exchange fees for proprietary data. I believe there is a clear need for prompt diligent effort, resourcefulness, and collaboration regarding ways for the Commission to fulfill this statutory responsibility in the most efficient and effective manner.

For example, the exchanges have offered various rationales and economic theories for their assertions that competitive forces discipline their proprietary data fees. As these fees continue to come under review in the various procedural contexts, I expect the Commission will be open to any reasonable framework for demonstrating sufficient competition. In addition, in a complex market, it is unlikely that any one metric would be dispositive. I expect that the exchanges will be forthcoming in presenting meaningful data and other factual support to meet their burden of demonstrating that the fees are consistent with the Exchange Act. I have also asked the staff to focus on these issues and report back to the Commission on potential approaches that could be adopted to fulfill its statutory responsibilities for exchange fees. There are many different approaches that economists have taken to show competition, here at the SEC and at the DOJ Antitrust Division and elsewhere.

Redfearn: The Exchange Act prescribes a series of substantive standards for SRO fees. These standards primarily are set forth in Section 6 for exchanges, in Section 15A for FINRA, and in Section 11A for market data fees. For simplicity's sake, I will focus today on the fees of exchanges and, in particular, on Section 6(b)(4), which requires that an exchange's rules "provide for the equitable allocation of reasonable dues, fees, and other charges among its members, issuers, and other persons using its facilities." Three key elements of this standard are that (1) an exchange's fees be set at a reasonable level, (2) the fees be equitably allocated across users of the exchange's facilities, and (3) the fees impose no undue burden on competition.

Division staff has been highly focused on the Commission's regulatory responsibilities for helping to ensure that exchange fees for market data and connectivity meet the relevant statutory standards. Pursuant to its delegated

authority to act on behalf of the Commission, the staff has suspended certain proposed fee changes pursuant to Section 19(b) and instituted proceedings to assess whether exchanges have met their burden of demonstrating that proposals meet the Exchange Act standards for fees. And courts have instructed us that "unquestioning reliance" on the representations of an SRO is not a sufficient basis for the Commission to make this finding.[31]

The Staff posted guidance in May 2019 to assist SROs in preparing fee filings that meet their burden of demonstrating compliance with Exchange Act standards.[32] This guidance of course only reflects staff views and is not a rule, regulation, or statement of the Commission. The Staff Fee Guidance notes that the Commission traditionally has taken a market-based approach when assessing the reasonableness of exchange fees. Under this approach, the Commission should begin by examining whether an exchange was subject to significant competitive forces in setting the terms of its proposal, including the level of fees.[33]

Assessing whether competition at the platform level constrains an exchange's overall fees is a factual issue for which financial information concerning the exchange's revenues, costs, and margins would be highly relevant. Currently, the best publicly available financial information for exchanges is provided by their annual updates to Form 1, which is the form for registration of a national securities exchange.[34] Although the usefulness of Form 1 financial information is limited in many respects, it is sufficient to demonstrate a substantial shift in the source of exchange revenues during the period from 2013 to 2018. For seven of the largest volume equity exchanges that operated throughout that period, their revenues from market data and connectivity rose at least 65 percent,[35] while the net revenues from transaction services rose by at most 13 percent.[36] During this same period, exchange operating expenses declined by four percent, while exchange operating income increased by 106 percent.

In this context, these changes raise questions about whether the current level of various exchange fees for market data and connectivity are reasonable, as well as whether these fees are equitably allocated across users of exchange facilities. Moreover, the fundamental question as to whether these fees are subject to competitive forces remains an important and concerning question.

In light of the continuing concerns over whether exchanges have demonstrated the fairness, reasonableness and equitable allocation of fees for market data and connectivity, Division staff is considering a variety of approaches for assessing the level and allocation of SRO fees. We have been and will continue to gather and evaluate relevant data, including potentially data related to profitability, return on assets, or other metrics, or a combination of metrics, as appropriate. And we will continue to assess theories that potentially bear on these issues. In the meantime, through the rulemaking proposals previously discussed, we are attempting to introduce a world of data that is sufficient in content, competitive in speed, and subject to market forces, with data fees that are subject to notice and comment and Commission approval.

ENDNOTES:

[1] *See* Chairman Jay Clayton and Director Brett Redfearn, Equity Market Structure 2019: Looking Back & Moving Forward (Mar. 8, 2019) ("2019 Remarks"), available at https://www.sec.gov/news/speech/clayton-redfearn-equity-market-structure-2019; Chairman Jay Clayton, Remarks at the Equity Market Structure Symposium Sponsored by the University of Chicago and the STA Foundation (Apr. 10, 2018), available at https://www.sec.gov/news/speech/speech-clayton-2018-04-10; Director Brett Redfearn, Remarks at the Equity Market Structure Symposium Sponsored by the University of Chicago and the STA Foundation (Apr. 10, 2018), available at https://www.sec.gov/news/speech/speech-redfearn-2018-04-10.

[2] Those principles are: (i) fidelity to the SEC's mission to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation; (ii) focusing on the long-term interests of Main Street investors; (iii) facilitating public transparency that can energize competitive forces to benefit investors; (iv) retrospectively reviewing Commission rules to assess whether they are functioning as intended, particularly as technology spurs new market mechanisms and trading practices;

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and (v) coordinating and communicating with other regulators and the stakeholders in the markets that we oversee. 2019 Remarks, supra note 2.

[3]*See* Chairman Jay Clayton, Remarks to the Economic Club of New York (Sept. 9, 2019), available at https://www.sec.gov/news/speech/speech-clayton-2019-09-09. *See also, e.g.,* Paul A. Samuelson, "The Pure Theory of Public Expenditure," The Review of Economics and Statistics, Vol. 36, No. 4 (Nov. 1954), pp. 387-389; Paul A. Samuelson, "Diagrammatic Exposition of a Theory of Public Expenditure," The Review of Economics and Statistics, Vol. 37, No. 4, (Nov. 1955), pp. 350-356.

[4]During oral argument, counsel for Nasdaq recognized the Commission's ability to request data from certain market participants. Oral Argument, *New York Stock Exchange LLP, et al v. SEC*, 19-1042 (D.C. Cir. Oct. 11, 2019), available at www.cadc.uscourts.gov/recordings/recordings2019.nsf/CBBCB1B8348A142185258490005718B8/$file/19-1042.mp3.

[5]Panelist views at the Roundtable are summarized in the 2019 Remarks, supra note 2. The transcript for the Roundtable on Market Structure for Thinly-Traded Securities is available at https://www.sec.gov/spotlight/equity-market-structure-roundtables/thinly-traded-securities-rountable-042318-transcript.txt.

[6]Commission Statement on Market Structure Innovation for Thinly Traded Securities, Securities Exchange Act Release No. 87327 (Oct. 17, 2019), 2019 WL 5420743 (Oct. 24, 2019).

[7]These other efforts have included actions under the JOBS Act to promote emerging growth companies, such as by expanding their opportunities to enter the public capital markets. *See, e.g.,* Chairman Jay Clayton, Modernizing our Regulatory Framework: Focus on Authority, Expertise and Long-Term Investor Interests (Nov. 14, 2019), available at https://www.sec.gov/news/speech/clayton-modernizing-our-regulatory-framework-111419. Small and mid-size companies have been and will continue to be a priority at the SEC.

[8]Division of Trading and Markets, Background Paper on the Market Structure for Thinly Traded Securities, available at https://www.sec.gov/rules/policy/2019/thinly-traded-securities-tm-background-paper.pdf.

[9]Comments on the Commission's Statement are available at https://www.sec.gov/comments/s7-18-19/s71819.htm.

[10]Panelist views at the Roundtable were summarized in our 2019 Remarks, supra note 2. The transcript for the Roundtable on Regulatory Approaches to Combatting Retail Fraud is available at https://www.sec.gov/spotlight/equity-market-structure-roundtables/retail-fraud-round-roundtable-092618-transcript.pdf.

[11]*See* Publication or Submission of Quotations Without Specified Information, Securities Exchange Act Release No. 87115 (Sept. 25, 2019), 84 FR 58206, 58210 (Oct. 30, 2019) ("Rule 15c2-11 Proposing Release").

[12]*See* supra note 12.

[13]Rule 15c2-11 Proposing Release, supra note 13.

[14]Regulation NMS, Securities Exchange Act Release No. 71808 (June 9, 2005), 70 FR 37496, 37557 (June 29, 2005) ("Regulation NMS Release").

[15]The views of panelists at the Roundtable are summarized in our 2019 Remarks, supra note 2. The full set of materials for the Roundtable on Market Data and Market Access, including agenda, panelists, a transcript of the panel discussion, and comments from the public, are available at https://www.sec.gov/spotlight/equity-market-structure-roundtables.

[16]*See, e.g.,* Transcript of Day One of Roundtable on Market Data and Market Access (Oct. 25, 2018) ("Day One Transcript"), available at https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf, at 65-66 (Mehmet Kinak, T. Rowe Price).

[17]Regulation NMS Release, 70 FR at 37503.

[18]Usage statistics for CTA plan data are available at https://www.ctaplan.com/publicdocs/CTAPLAN_Population_Metrics_4Q2019.pdf.

[19]In the fourth quarter of 2019, per-quote data usage for NYSE-listed securities was 692 million quotes. This includes non-professional users that are not classified as monthly subscribers and professional users that choose to report their usage on a per-quote basis. We must ensure that NMS market data is sufficient to meet the needs of investors and other market participants as markets evolve and that it is available on terms that facilitate its widespread availability. This is a primary objective of all three of our initiatives—helping to ensure fair and reasonable fees, expanding governance to include non-SROs, and enhancing infrastructure to improve data quality.

[20]Rescission of Effective-Upon-Filing Procedure for NMS Plan Fee Amendments, Securities Exchange Act Release No. 87193 (Oct. 1, 2019), 84 FR 54794 (Oct. 11, 2019).

[21]*See* Securities Exchange Act Rel. 87193.

[22]Notice of Proposed Order Directing the Exchanges and the Financial Industry Regulatory Authority to Submit a New National Market System Plan Regarding Consolidated Equity Market Data, Securities Exchange Act Release No. 87906 (Jan. 8, 2020), available at https://www.sec.gov/rules/sro/nms/2020/34-87906.pdf.

[23]Order Directing the Exchanges and the Financial Industry Regulatory Authority to Submit a New National

Market System Plan Regarding Consolidated Equity Market Data, Securities Exchange Act Release No. 88827 (May 6, 2020), available at https://www.sec.gov/rules/sro/nms/2020/34-88827.pdf.

[24]Market Data Infrastructure, Securities Exchange Act Release No. 88216 (Feb. 14, 2020), 85 FR 16726 (Mar. 24, 2020) ("Infrastructure Release").

[25]*See* Infrastructure Release, 16823-16824.

[26]Regulation NMS Release, 70 FR at 37523 n. 215 (a trading center's compliance with Rule 611 "will be assessed based on the times that orders and quotations are received, and trades are executed, at that trading center").

[27]Under Section 19(b) of the Exchange Act, the Commission cannot approve an SRO's proposed rule change unless it finds that the proposal is consistent with the Exchange Act. Section 19(b)(3)(A) provides that a proposed rule change takes effect upon filing with the Commission if the SRO designates the proposal as establishing or changing a fee, but Section 19(b)(3)(C) also provides that the new or changed fee may be enforced by the SRO to the extent it is not inconsistent with the Exchange Act, the rules thereunder, and other applicable law. Section 19(b)(3)(C) further provides that, within 60 days of filing, the Commission may summarily suspend an immediately effective fee change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.

[28]*See* The Nasdaq Stock Market v. SEC, No. 18-1292 (D.C. Cir. June 5, 2020), available at https://www.cadc.uscourts.gov/internet/opinions.nsf/127CE4C0762C082F8525857E00506366/$file/18-1292-1845826.pdf.

[29]*See, e.g.,* Day One Transcript, supra note 19, at 48 (Mehmet Kinak, T. Rowe Price) and at 198 (Joseph Wald, Clearpool Group); SIFMA Letter on Roundtable on Market Data and Market Access (received on Oct. 24, 2018) available at https://www.sec.gov/comments/4-729/4729-4559181-176197.pdf.

[30]The letter notes that certain information is only accessible via proprietary data feeds, which supply information exclusive to the exchange where the data originates, and that the proposal indicates that increases in proprietary data fees have outpaced increases in NMS market data fees. The DOJ states that these characteristics "would tend to indicate that Prop Data products lack substitutes, which would in turn enable the exchanges to exercise market power in determining their pricing of these products because they are the only data provider in their own markets." DOJ, Comments of the United States Department of Justice (May 26, 2020), available at https://www.sec.gov/comments/s7-03-20/s70320-7228535-217028.pdf.

[31]*See Susquehanna International Group, LLP v. Securities and Exchange Commission*, 866 F.3d 442, Fed. Sec. L. Rep. (CCH) P 99838 (D.C. Cir. 2017).

[32]Division of Trading and Markets, Staff Guidance on SRO Rule Filings Relating to Fees (May 21, 2019) ("Staff Fee Guidance"), available at https://www.sec.gov/tm/staff-guidance-sro-rule-filings-fees.

[33]Both the courts and the Commission have recognized that an exchange's costs may be relevant in determining the reasonableness of fees, even when determining whether competitive forces constrain the fees at issue. *See* Staff Fee Guidance at n. 26.

[34]Form 1 financial information is discussed in the Infrastructure Release, supra note 27, 85 FR at 16817.

[35]The exact amount of exchange revenues derived from market data and connectivity cannot be calculated with Form 1 financial information.

[36]Net revenues from transaction services are calculated by deducting the direct cost of generating such revenues (such as liquidity rebates, brokerage and clearing fees, and Section 31 fees, which are presented separately on exchange financial statements) from total transaction revenues.

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FROM THE EDITOR

At Long Last *Liu*

The recent Supreme Court ruling in *Liu v. Securities and Exchange Commission* is the end of a battle that began in 2016, when the SEC sued Charles Liu and Xin (Lisa) Wang, who had been raising money from investors under the EB-5 green card program. The SEC alleged Wang and Liu had misappropriated funds and defrauded their investors. The U.S. District Court for the Central District of California ruled in favor of the SEC, ordering disgorgement of the entire amount raised from investors, imposing penalties equal to Liu and Wang's salaries, and issuing a permanent injunction banning the pair from raising money under the EB-5 program.

Liu and Wang appealed to the Ninth Circuit Court of Appeals, which also ruled in favor of the SEC. At last, they appealed to the Supreme Court, arguing, as in their other cases, that the SEC lacked the legal authority to ask a court to require disgorgement of all funds raised from their investors. After more than six months, the Supreme Court has weighed in.

Our lead article, by Gibson Dunn's Avi Weitzman and Tina Samanta, succinctly breaks down the ruling. As the authors write, "if the measure of a ***good*** compromise is whether it leaves both sides equally dissatisfied, as the old adage goes, then the Supreme Court's recent ruling in *Liu v. Securities and Exchange Commission* may be considered a ***great*** compromise."

There's something to disappoint each party. The Supreme Court vacated the lower court's judgment containing a disgorgement order. Yet they *also* rejected the petitioners' principal claim that the SEC has no statutory authority to seek disgorgement. "Rather, the Court made clear that the SEC is permitted to seek disgorgement as an equitable remedy in federal court enforcement actions." But yet again, the Court *also* cabined the SEC's disgorgement remedy in significant ways: "narrowing it only to net profits (deducting "legitimate expenses"); clarifying that the remedy should be imposed only "for the benefit" of victim-investors, not the general public; and limiting their ability to seek disgorgement on a joint-and-several basis against codefendants."

So we have a Supreme Court ruling that, as the authors note, will likely prove to be a "quagmire" for the lower courts in the future, each looking to determine "how to implement disgorgement in light of the Court's general guidance in *Liu*." No doubt, the *Liu* ruling will have substantial implications for the SEC's enforcement program. "But only time—and likely years of additional litigation—will spell out the full implications of the decision," Weitzman and Samanta write. "Until then, the only sure thing is that the Supreme Court's ruling has left both sides dissatisfied victors."

Chris O'Leary, Managing Editor

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