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FROM *VAN GORKOM* TO *PLX TECH*, DELAWARE COURTS GUIDE DIRECTORS & ADVISORS IN THE CONTEXT OF THE SALE OF CORPORATE CONTROL

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On October 16, 2018, the Delaware Court of Chancery issued a post-trial decision in *In re PLX Tech. Inc. S'holders Litig.*,[1] involving the merger between PLX Technology, Inc. and Avago Wireless (U.S.A.) Manufacturing Inc., now known as Broadcom Inc., which closed on August 12, 2014. This decision is consistent with a decades-old proposition of Delaware law that directors "may not avoid [their] active and direct duty of oversight in a matter as significant as the sale of corporate control"[2] by abdicating this duty to others, such as management,[3] a controlling stockholder,[4] a financial advisor,[5] or, as expanded in *PLX Tech.*, a stockholder activist who is serving as a director.[6]

In addition to this general proposition, the Court in *PLX Tech.* offers specific guidance to directors, activists who serve as directors, and their advisors in the context of the sale of corporate control. This article highlights the key rulings of *PLX Tech.*, and, based upon these rulings, discusses the guidance offered by the Court.

Background

After discussions that commenced in April 2011, PLX and Integrated Device Technology, Inc. entered a merger agreement on April 30, 2012, in which IDT agreed to acquire PLX at a price of $7 per share, payable 50% in cash and 50%

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in stock. Thereafter, PLX's financial advisor, Deutsche Bank, solicited competitive bids, resulting in one all-cash bid of $5.75 per share from Avago. The Board of Directors of PLX declined to pursue the bid from Avago and disclosed the existence of a competing bid (but did not disclose the identity of the bidder or the bid price) to the stockholders of PLX in connection with the IDT transaction. The merger between PLX and IDT was abandoned on December 19, 2012, after the Federal Trade Commission moved to block the transaction on antitrust grounds.

Potomac commenced an activist campaign in which it advanced the position that PLX should be sold immediately, and the most likely buyer was the unidentified competing bidder that emerged during the IDT transaction.

The abandonment of the merger between PLX and IDT caused the stock price of PLX to plummet, attracting the attention of Potomac Capital Partners II LP, an activist hedge fund. On January 25, 2013, Potomac disclosed that it owned 5.1% of the shares of PLX, acquiring its position at prices ranging from $3.46 to $4.55 per share. Potomac later increased its position to 9.4%. Potomac commenced an activist campaign in which it advanced the position that PLX should be sold immediately, and the most likely buyer was the unidentified competing bidder that emerged during the IDT transaction. As recognized by the Court, Eric Singer, the co-managing member of Potomac, believed that Potomac would achieve substantial short-term profits if PLX was sold to the unidentified competing bidder. Notwithstanding the activist campaign, the Board did not agree that an immediate sale of PLX was in PLX's best interest.[7]

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During March 2013, Potomac initially nominated five candidates (including Singer and four individuals who were independent of Potomac) to replace a majority of the eight-member Board, and during November 2013, Potomac conducted a proxy solicitation and nominated three candidates (including Singer and two individuals who were independent of Potomac) to replace a minority of the Board. On December 6, 2013, Institutional Shareholder Services Inc. endorsed Potomac's slate. On December 18, 2013, PLX held its regular annual stockholder meeting, during which the stockholders elected the Potomac-nominated candidates (Singer, Martin Colombatto, and Stephen Domenik) to the Board.[8]

The senior executive described the acquisition of PLX as "an interesting little deal but only at the right price," suggesting that the acquisition of PLX was a "$300M deal," which equated to $6.53 per share.

Contemporaneously with the election of the Potomac-nominated candidates to the Board, Avago was acquiring LSI Corp., one of PLX's competitors. Deutsche Bank advised Avago in connection with the acquisition. On December 19, 2013, a senior executive of Avago contacted Deutsche Bank and explained that, although Avago "saw the PLX BoD transition," because of Avago's acquisition of LSI, Avago would be in the "penalty box" until the LSI acquisition closed—an approximately four-month period. After the LSI acquisition closed, however, Avago would be "open for business on all topics," including the potential acquisition of PLX. In fact, the senior executive described the acquisition of PLX as "an interesting little deal but only at the right price," suggesting that the acquisition of PLX was a "$300M deal," which equated to $6.53 per share.

Deutsche Bank spoke with Singer later that day and "gave [Singer] the color" of its conversation with the senior executive of Avago. As a result of Deutsche Bank's discussion with Singer, Singer knew (*i*) the continuing interest of Avago in acquiring PLX, (*ii*) the price that Avago would be willing to pay, and (*iii*) the timing of a potential acquisition. Although PLX held an informal meeting (which included Deutsche Bank) to provide information to Singer, Colombatto, and Domenik regarding PLX and PLX's sale process on December 20, 2013, neither Singer nor Deutsche Bank (*i*) informed PLX regarding Avago's call with Deutsche Bank, (*ii*) shared Avago's plan to return to PLX after completing the LSI acquisition, or (*iii*) mentioned the valuation of $300 million that Avago was contemplating.

In addition to the proper placement of the burden, PLX Tech. offers important guidance to directors and their advisors regarding the directors' ability to change their position in the context of the sale of corporate control.

On January 23, 2014, at a formal meeting of the Board and at Singer's request, the Board

appointed Singer to serve as Chair of the three-member Strategic Alternatives Special Committee, which was charged with exploring strategic alternatives for PLX. On February 7, 2014, the Special Committee held its first meeting. Although Avago was discussed, Singer did not mention the information that he received from Deutsche Bank regarding Avago.[9]

On May 9, 2014, Deutsche Bank informed Singer that Deutsche Bank received a call from Barclays Capital Inc., in which Barclays told Deutsche Bank that Barclays was advising Avago in connection with a potential bid for PLX. Deutsche Bank also reported the call to the Chief Executive Officer of PLX, who updated the other members of the Board. During May 9-17, 2014, Deutsche Bank had a number of calls with Barclays and Avago. On May 22, 2014, Avago sent a proposal to PLX in which Avago offered to acquire PLX "at a price of $6.25 per share." During May 23-31, 2014, Avago and PLX engaged in negotiations that resulted in Avago offering a price of $6.50 per share.[10]

The offer, however, was below the valuation range generated by a business plan prepared by management of PLX, which had been prepared in December 2013, approved by the Board, and relied upon by the Board when making decisions in the ordinary course of business. Specifically, Deutsche Bank prepared a discounted cash flow analysis based upon management's five-year projections (the "December 2013 Projections") that generated a valuation range of $6.90 to $9.78 per share, with $8.27 at the midpoint. According to the Court, the Special Committee and Deutsche Bank requested that "management prepare a new and materially lower set of projections" (the "June 2014 Projections").[11] Deutsche Bank considered the June 2014 Projections as the "Base Case" and the December 2013 Projections as the "Upside Case." After presenting the two sets of projections to the Board, the directors asked for an explanation of the changes. Without ever receiving an explanation, the Board approved Deutsche Bank's use of the June 2014 Projections for its valuation work. The discounted cash flow analysis based upon the June 2014 Projections prepared by Deutsche Bank yielded a range of $5.07 to $6.99 per share, with $5.98 at the midpoint.[12]

In addition to the issues relating to "divergent interest," directors should be sensitive to issues relating to the disclosure of projections and financial analyses.

On June 23, 2014, Avago and PLX formally announced the merger. In the recommendation statement that the Board sent to stockholders, the Board did not disclose Avago's contact with Deutsche Bank and claimed that the June 2014 Projections had been prepared in the ordinary course of business. In addition, the Board failed to disclose a discounted cash flow analysis based upon the December 2013 Projections that Deutsche Bank prepared and presented to the board during May 2014. On August 12, 2014, the merger closed. Each publicly-held share of PLX common stock was converted into the right to receive $6.50 in cash.

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On July 14, 2014, plaintiffs filed an action naming as defendants the members of the Board, Potomac, Avago, and the acquisition subsidiary that Avago used to effectuate the merger. Although plaintiffs initially sought a preliminary injunction, plaintiffs withdrew their request for an injunction based upon adequacy of money damages. After motions to dismiss, an amended complaint (adding Deutsche Bank as a defendant), and other motions to dismiss, on September 3, 2015, the Court dismissed the claims against Avago, Colombatto, and Domenik.[13] In dismissing the claims against Colombatto and Domenik, the Court stated:

> They never flip-flopped. They are not in the same position of dual fiduciaries as Singer. They are independent outsiders. Their only relationship is that Potomac nominated them. Nominating somebody is not a disqualifying interest. The plaintiffs haven't come up with anything else to tie these folks in, and as I say, there isn't this pattern of back-and-forth, back-and-forth and sort of strange resist-cave, resist-cave that I think allows the inference to be drawn at the pleading stage.[14]

On August 17, 2016, plaintiffs settled with all of the defendants, except Potomac. The Court denied Potomac's motion for summary judgment on February 6, 2018, and a trial occurred during April 10-12, 2018.[15]

Plaintiffs sought damages from Potomac for aiding and abetting breaches of fiduciary duty. During trial, plaintiffs proved by a preponderance of the evidence that (*i*) "the directors breached their fiduciary duties by engaging in a sale process without knowing critical information regarding Avago's communications with Deutsche Bank in December 2013,"[16] (*ii*) "the directors breached their duty of disclosure when recommending that the stockholders tender, both by failing to disclose Avago's communications with Deutsche Bank in December 2013, and by depicting the June 2014 Projections as having been prepared in the ordinary course of business," and (*iii*) "Potomac, through Singer, knowingly participated in the directors' breaches of duty."[17] Plaintiffs, however, did not prove any causally related damages, and, thus, judgment was entered in favor of Potomac. Specifically, relying upon *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd.*,[18] the Court held that plaintiffs' experts' discounted cash flow valuation (primarily based upon the December 2013 Projections) was not sufficiently persuasive to support a damages award of $9.86. In so holding, the Court explained:

> The Delaware Supreme Court has explained that when a widely held, publicly traded company has been sold in an arm's-length transaction, the deal price has "heavy, if not overriding, probative value." Although this decision has found that the sale process was flawed, largely because of Singer and Deutsche Bank's failure to disclose Avago's tip to the rest of the Board, I believe the sale process was sufficiently reliable to exclude the plaintiffs' damages contention.[19]

Guidance to Directors & Their Advisors

Initially, it is important for directors and their advisors to note that *PLX Tech.* is the first action since *Corwin v. KKR Financial Holdings, LLC,*[20] to survive a motion to dismiss and to go to trial. Interestingly, the Court placed the

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burden on plaintiffs to plead that the vote of the stockholders was uninformed and/or coerced. During trial, however, the Court placed the burden on Potomac to prove that the vote of the stockholders was informed and not coerced (consistent with the fact that *Corwin* is, post-pleading stage, an affirmative defense).

Interestingly, the Court placed the burden on plaintiffs to plead that the vote of the stockholders was uninformed and/or coerced. During trial, however, the Court placed the burden on Potomac to prove that the vote of the stockholders was informed and not coerced.

In addition to the proper placement of the burden, *PLX Tech.* offers important guidance to directors and their advisors regarding the directors' ability to change their position in the context of the sale of corporate control. Although a change of position is permitted,[21] directors should be sensitive to the "flip-flop[]," the "back-and-forth," and the "resist-cave" that the Court found to be problematic. Indeed, the rationale for directors' change of position should be based upon advice, information, and/or discussion and deliberation with other directors, and should not be based upon "activist pressure,"[22] especially if the "pressure" is being applied by an activist with an "interest" that may be viewed as "divergent" from the interest of the corporation.[23]

Further, directors should be sensitive to advisors that arguably have a "divergent interest." As highlighted by the Court:

> One factor was Deutsche Bank's contingent fee arrangement, which gave Deutsche Bank a powerful financial incentive to favor a sale over having PLX remain independent. The other factor was Deutsche Bank's longstanding and thick relationship with Avago, which included advising Avago contemporaneously on its acquisition of LSI. Avago announced the LSI deal on December 16, 2013, meaning that Deutsche Bank was representing both PLX and Avago during PLX's market check in fall 2013. It also meant that Deutsche Bank was representing both PLX and Avago on December 19, 2013, when [Avago] tipped Deutsche Bank about Avago's plan to acquire PLX for $300 million after it completed the LSI acquisition. Deutsche Bank only stopped formally representing Avago on the LSI deal in May 2014, days before Avago re-engaged with PLX. Deutsche Bank's ongoing relationship with Avago gave it a powerful incentive "to maintain good will and not push too hard" during the negotiations. From a formalistic standpoint, Deutsche Bank narrowly avoided simultaneously representing the buyer and the seller on the same deal, but when dealing with an industry that values relationships, and recognizing that bankers frequently provide advisory services first and document the engagement letter later, a reviewing court cannot ignore the situation that Deutsche Bank created. As with Singer's conflict, Deutsche Bank's position on both sides of the deal necessarily colors the court's assessment of the decisions that the directors made.[24]

Although Deutsche Bank's contingent fee arrangement is a "routine" fee arrangement in the context of a sale of corporate control,[25] this fee

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arrangement *coupled with* "Deutsche Bank's longstanding and thick relationship with Avago," and Deutsche Bank's failure to provide important information to the Board or the Special Committee (*e.g.*, failing to advise of its conversation with Avago on December 19, 2013), caused the Court to question the "incentive" of the financial advisor.[26]

In addition to the issues relating to "divergent interest," directors should be sensitive to issues relating to the disclosure of projections and financial analyses. Specifically, if projections exist prior to an offer being received by a corporation, and if "materially lower" projections are prepared after the offer is received by the corporation, then directors should disclose to the stockholders both sets of projections and accurately describe the projections (including an explanation of the need and/or rationale for the revised projections).[27] Simply stated, the directors should disclose the reasons for *why* the revised projections were prepared, and *why* the directors considered the revised projections. In *PLX Tech.*, although the December 2013 Projections and the June 2014 Projections prepared by management of PLX were disclosed, the December 2013 Projections were described as "aggressive" and the June 2014 Projections were described as "prepared in the ordinary course of business for operating purposes."[28] In holding that these descriptions were "misleading," the Court stated:

> In light of the circumstances surrounding their preparation, it was misleading for the Recommendation Statement to claim that the June 2014 Projections "were prepared in the ordinary course of business for operating purposes." The June 2014 Projections were prepared after Avago made its bid so that Deutsche Bank could use them in its fairness opinion.[29]

Likewise, if the different projections are applied to a financial analysis, which applications yield different valuation ranges, then directors should consider disclosing the valuation range relied upon by the directors *and* any higher valuation range that was presented to the directors. In *PLX Tech.*, for example, the Board relied upon Deutsche Bank's final analysis that yielded a valuation range of $6.39 to $8.98 per share, with a midpoint of $7.69, but a valuation range of $6.90 to $9.78 per share, with a midpoint of $8.27 per share, also was presented to the Board.[30] Although the Court stated that the Board's obligation to disclose the higher valuation range was "a close call" because (a) the higher valuation range "was not part of Deutsche Bank's final analysis," and (b) the midpoint of the lower valuation range was "only" 7% lower than the midpoint of the higher range, the Court concluded that the higher valuation range should have been disclosed because the entire range "exceeded both the directors' counteroffer and the eventual deal price."[31]

Guidance to Stockholder Activists & Their Advisors

Although stockholder activists do not owe fiduciary duties to the corporation or its stockholders, the situation changes if the activists are elected or appointed as directors. As recognized by the Court in *PLX Tech.* (relying upon the seminal decision of the Delaware Supreme Court in *Weinberger v. UOP, Inc.*[32]), the activists who are serving as directors have " 'dual

or multiple' fiduciary obligations"[33] that may create a "divergent interest," and, thus, may present circumstances that are ripe for a breach of fiduciary duty:

> [There is] no dilution of the duty of loyalty when a director holds dual or multiple fiduciary obligations and [there is] no 'safe harbor' for such divided loyalties in Delaware. If the interests of the beneficiaries to whom the dual fiduciary owes duties diverge, the fiduciary faces an inherent conflict of interest. If the interests of the beneficiaries are aligned, then there is no conflict.[34]

Although stockholder activists do not owe fiduciary duties to the corporation or its stockholders, the situation changes if the activists are elected or appointed as directors.

In *PLX Tech.*, prior to Singer serving as a director, the Board "did not agree that an immediate sale was in [PLX's] best interest."[35] In contrast, Potomac, through Singer, consistently supported the immediate sale of PLX. This disagreement regarding the immediate sale of PLX created a "divergent interest," and this "divergent interest" resulted in Singer's breach of fiduciary duty. As the Court held:

> The record in this case convinces me that Singer and Potomac had a divergent interest in achieving quick profits by orchestrating a near-term sale at PLX. During their activist campaign and subsequent proxy contest, Singer and Potomac argued vehemently that PLX should be sold quickly. Singer's thesis for investing in PLX depended entirely on a short-term sale to the other bidder who emerged during the go-shop period for the IDT transaction. He never prepared any *valuation or other analysis of the fundamental value of PLX*. He lacked any ideas for generating value at PLX other than to sell it.[36]

In so holding, the Court demonstrated a sensitivity to the liquidity requirements/quick-exit strategies of certain classes of investors (*e.g.*, activists) in determining whether fiduciaries (*e.g.*, activists who serve as directors) have a conflict of interest.

Activists may protect themselves from the situation confronted by Potomac and Singer in *PLX Tech.* by recognizing that their short-term interest may be in conflict with the long-term interest of the corporation as determined by the other directors. Rather than pursuing their position to sell the corporation aggressively, activists who serve as directors should consider creating a process to convince the other directors that the activists' position is in the best interest of the corporation and its stockholders. The process should include a "valuation or other analysis of the fundamental value of" the corporation as a standalone entity.[37] The process, however, should not include the activists who serve as directors bullying and threatening the other directors into submission.[38] The process may take time, and the activists may desire immediate action, but the process may be in the best interest of the corporation and its stockholders, and, thus, the process may protect the directors (and the activists) from liability and damages.

In addition, the activists may consider appointing individuals to serve as directors who

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are independent of and not controlled by the activists. As stated by the Court, "[n]ominating somebody" to serve as a director "is not a disqualifying interest."[39] The activists should balance the benefit—the protection—of nominating independent individuals to serve as directors against the lack of "control" that the activists will have over the directors.

Finally, activists should be sensitive to disclosure issues. If activists serve as directors, then the activists often become the individuals who third parties contact regarding potential transactions regarding the corporation. After such contact, the activists should inform the other directors of the contact and permit the directors to make decisions regarding the contact, including whether to disclose the contact to the stockholders if approval of a sale of corporate control is sought from the stockholders. In sum, the activists should not withhold information that the activists receive as directors from the other directors in order to achieve an objective that is favored by the activists; rather, the activists should share the information with the other directors in order to achieve an objective that is determined by the directors to be in the best interest of the corporation and its stockholders.

ENDNOTES:

[1]*In re PLX Technology Inc. Stockholders Litigation*, 2018 WL 5018535 (Del. Ch. 2018). On November 13, 2018, plaintiffs filed a Notice of Appeal and are appealing the decision of the Court to the Delaware Supreme Court.

[2]*Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1989); *see also Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989) (Delaware courts "look particularly for evidence of a board's active and direct role in the sale process").

[3]*See Smith v. Van Gorkom*, 488 A.2d 858, 874-75, 46 A.L.R.4th 821 (Del. 1985) (overruled by, Gantler v. Stephens, 965 A.2d 695 (Del. 2009)).

[4]*See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 927 (Del. 2003).

[5]*See RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816, 845, 853 n. 117, 855 (Del. 2015).

[6]*See In re PLX Technology Inc. Stockholders Litigation*, 2018 WL 5018535, at *45-*47 (Del. Ch. 2018).

[7]*See id.* at *4-*5.

[8]*See id.* at *12-*13.

[9]*See id.* at *15-*16.

[10]*See id.* at *17-*23.

[11]*Id.* at *2. The Court did not refer or otherwise cite to the record in support of this statement, and, thus, support for this statement is unclear. See id.

[12]*See id.* at *13-*15, *24-*26.

[13]*See id.* at *26-*27.

[14]Telephonic Ruling on Defendants' Motion to Dismiss, *In re PLX Tech. Inc. S'holders Litig.*, 2015 WL 13501398, at 12 (Del. Ch. 2015).

[15]*See PLX Tech.*, 2018 WL 5018535, at *27.

[16]In so holding, the Court stated that "[t]he directors other than Singer should not be blamed for this oversight in any morally culpable sense: Singer and Deutsche Bank withheld the information from them. In terms of fulfilling their fiduciary duties, however, the directors fell short." *Id.* at *2.

[17]*Id.*

[18]*Dell, Inc. v. Magnetar Glob. Event Driven*

Master Fund Ltd., 177 A.3d 1, 37-38 (Del. 2017).

[19]*PLX Tech.*, 2018 WL 5018535, at *54 (quoting *Dell*, 177 A.3d at 30).

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

[21]*See Air Products and Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48, 128 (Del. Ch. 2011).

[22]*See PLX Tech.*, 2018 WL 5018535, at *45.

[23]*See id.* at *42 ("[t]he record in this case convinces me that Singer and Potomac had a divergent interest in achieving quick profits by orchestrating a near-term sale at PLX").

[24]*Id.* at *43.

[25]*In re Atheros Communications, Inc., S'holder Litig.*, 2011 WL 864928, at *8 (Del. Ch. 2011) ("[c]ontingent fees are undoubtedly routine; they reduce the target's expense if a deal is not completed; perhaps, they properly incentivize the financial advisor to focus on the appropriate outcome").

[26]*See PLX Tech.*, 2018 WL 5018535, at *43.

[27]*See id.* at *2; *see also In re Rural Metro Corp.*, 88 A.3d 54, 77-78, 104-05 (Del. Ch. 2014), decision clarified on denial of reargument, 2014 WL 1094173 (Del. Ch. 2014) and subsequent determination, 102 A.3d 205 (Del. Ch. 2014).

[28]*PLX Tech.*, 2018 WL 5018535, at *35.

[29]*Id.* at *37.

[30]*See id.* at *38.

[31]*Id.*

[32]*Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

[33]*PLX Tech.*, 2018 WL 5018535, at *43 (quoting *Weinberger*, 457 A.2d at 710).

[34]*Id.* (quotations omitted).

[35]*Id.* at *5.

[36]*Id.* at *42 (emphasis added).

[37]*Id.*; *see also id.* at *21, *46.

[38]*See id.* at *44-*45; *see also id.* at *6 n.60, *9 n.114, *9 n.118, *42 n.506.

[39]Telephonic Ruling on Defendants' Motion to Dismiss, *PLX Tech.*, 2015 WL 13501398, at 12.

FINRA DISCIPLINARY ACTIONS SHOW FINES INCREASED IN 2018, SAYS ANNUAL STUDY

From Eversheds Sutherland

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The disciplinary actions reported by the Financial Industry Regulatory Authority (FINRA) in 2018 shows that the dollar amount of fines increased compared with 2017, although the number of cases and amount of restitution were down, according to Eversheds Sutherland's annual study.

In addition, anti-money laundering cases continued to lead to the largest dollar amount of fines, the study shows. Eversheds Sutherland Partner Brian L. Rubin and Counsel Adam C. Pollet conduct their annual study by reviewing FINRA's monthly disciplinary reports, press releases, and online database.

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The Results

Fines, Restitution & Disciplinary Actions

The dollar total of the fines reported by FINRA in 2018 increased slightly to $68 million from $65 million in 2017, a 5% jump, yet down significantly (61%) from the record-setting fines of $176 million in 2016.[1] The fines in 2018 were also 28% lower than the $94 million in fines reported in 2015. Despite this reduction, fines have increased by 143% in the 10 years since 2008, when FINRA assessed fines of $28 million.

Although the dollar amount of fines increased, the number of very large fines declined in 2018. FINRA assessed 13 fines of $1 million or more (what the authors call "supersized" fines). In contrast, in 2017, FINRA assessed 15 "supersized" fines. Similarly, in 2018, FINRA assessed five fines of $5 million or more (what the authors call "yuuuge" fines). In contrast, in 2017, two cases resulted in "yuuuge" fines.

In 2018, restitution ordered by FINRA was down significantly. FINRA reported restitution of approximately $31 million in 2018, a decrease of 54% from the $67 million in restitution reported in 2017 and well below the record of $96 million reported in 2015. The decrease in restitution is less pronounced when FINRA's overall monetary sanctions are analyzed. In 2018, the total monetary sanctions ordered by FINRA (fines, restitution, and disgorgement) were $124 million. The total sanctions ordered in prior years were as follows: $150 million in 2017; $207 million in 2016; and, $193 million in 2015.

The number of cases reported by FINRA also decreased last year. FINRA reported 638 disciplinary actions in 2018, a decrease of about 37% from the 1,007 cases FINRA reported in 2017.[2] Further, the number of individuals barred or suspended and firms expelled decreased in 2018 compared to 2017. FINRA barred 211 individuals in 2018, remaining fairly constant from the 214 individuals in 2017, a decrease of 1%. The number of firms expelled by FINRA decreased from seven in 2017 to four in 2018, a decrease of 43%. The number of individuals suspended decreased significantly from 413 in 2017 to 254 in 2018, a decrease of 38%.

"Last year, the dollar amount of fines per case went up dramatically while the number of cases decreased from the previous year, appearing to indicate that FINRA is coming down harder on firms when it decides to bring a case," says Rubin, the study's co-author. "FINRA addressed an array of topics in 2019, continuing its focus on anti-money laundering, while also pursuing more 'nuts and bolts' issues like suitability, variable annuities, and supervisory policies and procedures."

The chart below[3] displays FINRA's fines and the number of disciplinary actions during each of the past 10 years:

FINRA's Sanctions Statistics, 2009-2018[3]

	Fines Reported	Percentage Change	Disciplinary Actions		Percentage Change
			FINRA Statistics	FINRA Online Data	
2009	$50 million	--	1,158	1,040	--
2010	$42 million	(16)	1,310	1,147	10
2011	$72 million	71	1,488	1,249	9
2012	$69 million	(4)	1,541	1,281	3
2013	$60 million	(13)	1,535	1,283	0.2
2014	$134 million	123	1,397	1,212	(6)
2015	$94 million	(30)	1,462	1,344	11
2016	$176 million	87	1,434	1,201	(11)
2017	$65 million	(58)	1,369	1,007	(16)
2018	$68 million	(5)	TBD	638	(37)

The chart below displays the restitution FINRA reported during each of the past 10 years:

FINRA's Restitution Statistics, 2009-2017

	Restitution Reported	Percentage Change
2009	$8 million	--
2010	$6 million	(25)
2011	$19 million	217
2012	$34 million	79
2013	$10 million	(71)
2014	$32 million	220
2015	$96 million	200
2016	$28 million	(71)
2017	$67 million	136
2018	$31 million	(54)

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Top Enforcement Issues Measured by Total Fines Assessed

Listed below are the top FINRA enforcement issues for 2018 measured by total fines assessed:[4]

1. **Anti-money laundering (AML) cases** resulted in the most fines assessed by FINRA in 2018. This is the third year in a row that AML has been at the top of the Eversheds Sutherland Top Enforcement Issues list and the fifth year in a row that AML has appeared on the list. FINRA reported 17 AML cases in 2018, which resulted in $27.3 million in fines. While the number of cases is almost the same as last year (16 in 2017), the fines reported increased by $12.7 million in 2018, an increase of 87%. AML maintained the top spot due in part to the largest single fine FINRA assessed in any case in 2018 ($10 million).[5] In that case, the firm's AML surveillance system allegedly did not receive data from several systems, undermining its surveillance of wire and foreign currency transfers. The firm also allegedly failed to devote sufficient resources to the review of alerts generated by its AML surveillance system. Finally, FINRA claimed the firm did not reasonably monitor the deposit and subsequent sale of penny stocks for suspicious activity. Study co-author Pollet noted that "AML's presence at the top of this list for the third year in a row confirms that the financial services regulators—FINRA, the Securities and Exchange Commission (SEC), and the Financial Crimes Enforcement Network (FinCEN)—are aggressively continuing to monitor how firms handle their AML compliance obligations."

2. **Suitability cases** resulted in the second most in fines for FINRA in 2018, catapulting it into the Eversheds Sutherland Top Enforcement Issues list for the first time since 2015. FINRA reported 91 suitability cases, with $11.8 million in fines in 2018. The number of cases decreased 7% from the 98 cases brought in 2017, although the fines increased 228% from the $3.6 million in fines reported in 2017. FINRA also ordered $11.6 million in restitution in suitability cases, compared with $30.3 million in 2017. There were three large suitability cases this year related to variable annuities, described below, which resulted in fines of $6.7 million and $8 million in restitution. FINRA also fined a firm $713,000 and ordered $1.3 million in restitution for failing to supervise its representatives that had engaged in churning in customers' accounts.[6] In another matter, FINRA fined a firm $800,000 for failing to adequately supervise the suitability of its representatives' recommendations.[7]

3. **Variable Annuity cases** resulted in the third most fines for FINRA in 2018, pushing it back into the Eversheds Sutherland Top Enforcement Issues list for the first time since 2016. FINRA reported 28 variable annuity cases for a total of $8.1 million in fines. The number of cases increased 22% from the 23 cases brought

in 2017, and the dollar amount of fines increased 305% from the $2 million in fines reported in 2017. FINRA also ordered $8.7 million in restitution in variable annuity cases last year, compared with $428,000 in 2017. In one matter, FINRA fined a firm $4 million and ordered $2 million in restitution for failing to supervise the sale of variable annuity exchanges.[8] In another variable annuity matter, FINRA fined four affiliated firms a total of $1.69 million and ordered restitution of $6 million for failing to establish and implement adequate supervisory procedures regarding the sale of multi-share class variable annuities, especially L-shares.[9]

4. **Short Selling cases** resulted in the fourth most in fines for FINRA in 2018. This is the first year that short selling has appeared on this list since 2013. In 2018, FINRA reported seven short selling cases for a total of $7.8 million in fines. The number of cases decreased 70% from the 23 cases brought in 2017, but the dollar amount of fines increased 387% from the $1.6 million in fines reported in 2017. The appearance of short selling on this list was primarily the result of a single matter where a firm was fined $5.5 million for failing, despite numerous red flags and warnings, to establish supervisory procedures that were reasonably designed to achieve compliance with the requirements of Reg SHO which included failing to close-out fails-to-deliver, accepting short orders without first borrowing (or arranging to borrow) the security, and permitting the execution or display of short sales at prices less than or equal to the current national best bid.[10]

Enforcement Trends

1. **Cases Packing Harder Punch**—In 2018, FINRA brought 638 disciplinary actions, down considerably from previous years and continuing a trend from 2017. Although the number of cases was down significantly, the dollar amount of fines appears to be packing more of a punch. For example, in 2017, FINRA brought 1,007 cases[11] with fines totaling $65 million, for an average fine of approximately $65,000 per case. But in 2018, with 638 cases totaling $68 million fines, the average fine per case is approximately $107,000.

2. **FINRA Is a Second-Half Team**—Many of FINRA's big-ticket fines are brought in the second half of the year, often in year-end cases. In 2018, FINRA reported fines of $42 million in the second half of the year as compared to $26 million in the first half. Similarly, in 2017, FINRA levied $41 million in fines in the second half of the year and $24 million in the first half. In 2018, the large fines in the second half were in part the result of FINRA fining four firms $21 million in December 2018 alone, representing nearly one-third of the $68 million in total fines for the year.

3. **Share Class Case**—FINRA continues to pursue firms for failing to provide sales

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charge waivers for retirement plans and charitable organizations. In 2018, FINRA brought six enforcement actions against firms for failing to provide these sale charge waivers when applicable. FINRA levied fines in only two of the matters totaling $150,000, but ordered restitution of $3.1 million. This practice is consistent with a continuing trend of FINRA focusing on making harmed customers whole through restitution rather than fines.

4. **Inadequate Resources**—In a couple notable cases in 2018, FINRA cited firms for failing to commit sufficient resources to their regulatory obligations. These two matters resulted in sanctions of $10.8 million. In the first matter, FINRA alleged that the firm relied on three individuals to manually review suitability for more than 600 representatives in more than 250 branches.[12] As a result, FINRA found the firm failed to have a reasonable supervisory system for the suitability review of customer transactions. In the second matter, FINRA alleged that a firm failed to devote sufficient resources to review AML alerts, resulting in AML analysts carrying a large workload and failing to conduct sufficient investigations of potentially suspicious activity.[13] These cases are consistent with an approach outlined in a 2018 speech by FINRA's Director of Enforcement Susan Schroeder.[14] She stated that in disciplinary actions FINRA would be identifying the root cause of regulatory deficiencies.

ENDNOTES:

[1]The 2018 data comes from FINRA's monthly disciplinary reports, its Disciplinary Actions Online database, press releases, and other major news sources.

[2]The number of disciplinary actions has been identified by searching FINRA's Disciplinary Actions Online database because FINRA has not yet published its annual report or updated its "Statistics" webpage.

[3]The 2009-2017 data contained in this chart and the next chart can be found in AnchorFINRA's annual reports and FINRA's "Statistics" webpage. *See, e.g.*, FINRA 2015 Year in Review and Annual Financial Report, FINRA, *available at* http://www.finra.org/sites/default/files/2015_YIR_AFR.pdf, and Statistics, FINRA, https://www.finra.org/newsroom/statistics.Under Disciplinary Actions, the "FINRA 'Statistics' " are the number of disciplinary actions reported in FINRA's Annual Reports or "Statistics" webpage, while the "FINRA online data" is the number of actions listed on FINRA's Disciplinary Actions Online database. FINRA has not yet released its Annual Report or updated its "Statistics" webpage for 2018. "The Percentage Change" is calculated using the number of actions listed on FINRA's Disciplinary Actions Online database.

[4]Because cases may involve more than one alleged violation (*e.g.*, suitability and variable annuities), a case may be included in more than one category in this analysis.

[5]AWC No. 2014041196601 (Dec. 26, 2018).

[6]AWC No. 2012030564701 (Jun. 22, 2018).

[7]AWC No. 201403971101 (Sept. 11, 2018).

[8]AWC No. 2013035051401 (May 8, 2018).

[9]AWC No. 2015047177001 (Jul. 24, 2018).

[10]AWC No. 2014043143401 (Aug. 16, 2018).

[11]Since FINRA has not yet released its of-

ficial 2018 figures, the number of cases cited in these examples are from FINRA's Disciplinary Actions Online database for an "apples-to-apples" comparison.

[12]AWC No. 2014039071101 (Sept. 11, 2018).

[13]AWC No. 2014041196601 (Dec. 26, 2018).

[14]*See* Susan Schroeder, Remarks at SIFMA AML (Feb. 12, 2018), *available at* https://www.finra.org/newsroom/speeches/021218-remarks-sifma-aml.

CULTURE REFORM: A WORK STILL IN PROGRESS

By Thomson Reuters Regulatory Intelligence

This article was part of a newly released annual report, "The State of Regulatory Reform 2019: The Future of Financial Regulation," published by Thomson Reuters Regulatory Intelligence. You can download a copy of the report here: https://bit.ly/2UeQAVK.

The criminal charges against Goldman Sachs and two of its senior executives regarding their involvement in the Malaysian 1MDB scandal put into sharp relief a lingering reality: a decade after a near-systemic collapse exposed glaring cultural weaknesses in the financial services industry, there is still more work to do.

It is unclear whether the U.S. Department of Justice will accept Goldman's argument that the firm itself was not culpable in the bribery scandal involving Malaysia's state-owned sovereign wealth fund. Goldman says Tim Leissner, a former Goldman partner and top Asian dealmaker, was a "rogue" employee. Leissner has already pleaded guilty to money laundering and circumventing compliance controls over the 1MDB case. He has received a life ban in Singapore.

Earlier in 2018, a major banking scandal emerged in Australia, which had seemed immune to the behavioral fallout that emerged from the financial crisis.

The episode nevertheless demonstrates that despite initiatives to monitor employee behavior and strengthen corporate ethics, blind spots can still emerge in large, complex organizations. As seen time and again, the damage to an institution in reputation and financial costs can be enormous.

Goldman is far from alone. Earlier in 2018, a major banking scandal emerged in Australia, which had seemed immune to the behavioral fallout that emerged from the financial crisis. The country's four largest banks—Commonwealth Bank of Australia, Westpac, ANZ and National Australia Bank—were found to have engaged in numerous instances of misconduct, leading to the resignation of executives, and a regulatory overhaul of lending standards and poor behavior.

In Europe, a €200 billion money laundering scandal erupted at Danske Bank, Denmark's largest lender, prompting the ousting of its chief executive. The bank was found to have moved the billions of illicit funds through its Estonia branch for Russian clients.

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What do these events have in common? At a minimum, there was flagrant disregard for each institution's controls and policies, and behavior that put profit ahead of the risks created for each organization. This is not an uncommon theme.

In Goldman's case, there was also a breakdown in trust between management and senior executives charged with overseeing the firm's business in a remote part of the globe. As one former Goldman partner put it, when operating in emerging economies, the importance of selecting the right individual to run the business becomes magnified.

"You have to depend on the guy on the scene to get these things right," the former partner told Thomson Reuters Regulatory Intelligence. "You have to make sure that when considering a transaction, it is one that the firm wants to do, and therefore very important for the firm to have people they can trust. . . .In this case the key guy turned out to be a fraudster."

In the Danske Bank case, there was more widespread evidence of cultural breakdown. Jesper Nielsen, Danske's interim chief executive, has said the bank had a culture that "consistently reported too positively," allowing managers to overlook the potential crimes for a nine-year period.

A recent investigation into what went wrong found that all three lines of defense collapsed in this case. "It's a matter of internal collusion; it's an underestimation from management of the impact of this case; it's basically looking at this case as risk minimizing and not as crime. That might be the biggest mistake. We have a cultural thing we need to work on," Nielsen said.

If all of this looks too painfully familiar, one wonders how regulators might respond. Until now, they have argued firms should manage culture themselves, and they have adopted a supervisory approach based on setting broad principles rather than precise rules.

European Regulators: A Widening Focus on Culture

EU regulators will be evaluating progress in recent cultural initiatives and may further tailor their programs. UK regulators and the Dutch National Bank (DNB) have been leaders on bank culture and the role of supervisors in encouraging positive change. In the UK, the Senior Managers and Certification Regime has taken hold, designed to increase executive accountability with specific designations of responsibility. The Banking Standards Board has meanwhile been looking in depth at why bank employees believe it is futile to speak up when they see mistakes made.

Meanwhile, the Central Bank of Ireland (CBI) and Germany's BaFin are including culture and conduct risk in their workstreams.

European authorities including BaFin, the UK Financial Conduct Authority, the CBI and the DNB now meet regularly to promote the harmonization of standards for risk culture and conduct risk. These meetings may be institutionalized within a permanent working group at the EU or Basel level.

In 2018, the CBI also made significant moves to address conduct and culture within

Irish banks following the "tracker mortgage scandal," which saw banks wrongly deny customers favorable mortgage rates. It could cost them up to €500 million in fines and compensation.

Asian Outlook: Australia's Scandal Could Prompt Scrutiny

Asian regulators have lagged behind their western counterparts on culture, according to experts. With the Australian banking scandal still fresh in people's minds, however, there might be an incentive for banks and authorities in the region to see whether they are facing similar problems, and to head them off.

Up until now, only a few regulators in the Asia-Pacific region, such as those in Australia, Hong Kong and Singapore, have set specific expectations on culture and conduct, said Simon Topping, regulatory partner at KPMG China who is based in Hong Kong. This year, however, could see more Asian regulators issue guidance on culture, setting their expectations, he said.

"I don't think culture and conduct is a topic which regulators can deal with by specific requirements, but rather by principles. They are likely to make clear what their expectations are and what effects they expect to see," Topping said. Asian regulators are likely to focus on three main areas of conduct: increasing expectations on boards to have proper oversight of culture; increasing expectations and supervision of culture programs, conduct awareness and training; and an increase in emphasis on personal accountability on conduct, said Kevin Nixon, founder of Nixon Global Advisory in Sydney.

The use of financial technology for employee engagement and in identifying issues related to institutional or employee behavior is also expected to become prevalent, Nixon said.

"There is going to be an expectation on the use of technology, data analytics and artificial intelligence in managing conduct," he said.

The risk culture agenda, which focuses on how financial institutions view risk and what culture means to the way firms manage risk, will be a much bigger topic this year, said Keith Pogson, global assurance leader, banking and capital markets at EY in Hong Kong.

"Organizations will need to ask questions such as: is risk-taking part of your culture or not? Are you expecting your staff to proactively think about risk? What are the consequences to my organization? It is about the levers which the organization has in place, and about making sure that they are not only there but are also being used," he said.

U.S. Regulatory Patience Tested

The U.S. regulatory community lost its most vocal advocate for cultural change in 2018 with the retirement of William Dudley as president of New York Federal Reserve Bank. His successor, John Williams, has been relatively quiet on the subject. Officials at the bank have made it clear, however, that culture and conduct remain high on the agenda.

In a recent speech, Kevin Stiroh, head of the supervision group at the New York Federal

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Reserve, suggested regulators might need new tools when looking at culture reform. He included innovations in technology and behavioral science as areas worth considering.

Still, the Goldman Sachs 1 Malaysia Development Berhad (1MDB) scandal may be an important test case for U.S. regulatory patience.

In 2018, the Federal Reserve, exasperated by the lack of progress made by Wells Fargo's management at correcting faults found in the bank's governance and control functions, issued an unprecedented "cease-and-desist" order on the institution's future growth plans. Regulators might feel equally compelled to take more forceful action, should additional scandals emerge.

EQUITY MARKET STRUCTURE 2019: LOOKING BACK & MOVING FORWARD

A Speech by SEC Chairman Jay Clayton

Securities and Exchange Commission Chairman Jay Clayton spoke on March 8 at the Gabelli School of Business at Fordham University in New York City about the SEC's equity market structure agenda for 2019. This is a partial transcript of his remarks.

[. . .] One of our key responsibilities as regulators is to strive to ensure that, as technology changes, our regulations continue to drive efficiency, integrity, and resilience. As technology and business practices evolve, so must our regulatory framework. This is irrefutably true for the regulation of our U.S. equity markets, which have undergone a monumental transformation with the deployment of a vast array of advanced technologies in the last decade. As just one example, it is clear that technological change drives our understanding of best execution—said bluntly, for "best execution" to be true to its name, the in-practice requirements should reflect the trading ecosystem of the time. Vacuum tubes with folds of paper are no longer a component of what is "best." With that in mind, it is important that we reassess Regulation NMS, now 14 years old, as well as our understanding of best execution in today's marketplace.

Regulation NMS is the primary regulation governing equity market structure, yet it has remained largely untouched since first adopted in 2005. It was designed to address equity market structure challenges that were prevalent over a decade ago. It is clear that the market challenges we faced in the early 2000s are not the same as the issues that we confront over a decade later. Some of the challenges we face today may, in fact, be consequences of Regulation NMS and other rules. My view on Regulation NMS is, in summary: there are many areas that the Commission got right, some that may have missed their mark, and some that were positive in 2005 but may no longer be so.

Let's turn to particulars. Last year the SEC's Division of Trading and Markets hosted a series of roundtables to address three equity market structure topics—the market structure for thinly-traded securities, regulatory approaches to combating retail fraud, and market data and market access. The panelist discussions and public comments that the roundtables generated were extremely valuable and pro-

vided our staff with a clearer view of areas for improvement and potential rulemaking recommendations. In the remainder of our time today, we will highlight the equity market structure initiatives arising out of the three roundtables that I anticipate will be on the SEC's agenda for 2019 and beyond.

For each of the three roundtable topics, I will begin by noting some broad issues we are currently considering, and then Director Redfearn will follow with additional details. Note that I used the word "current." Our comment boxes for the roundtables remain open, and I encourage market participants to make their views known.

Thinly-Traded Securities

The quality of our markets for thinly-traded securities is an area where review is needed. Today, Regulation NMS mandates a single market structure for all exchange-listed stocks, regardless whether they trade 10,000 times per day or 10 times per day. The primary focus of last year's Roundtable on Market Structure for Thinly-Traded Securities was the particular challenges facing companies and investors in this segment of the market. Roundtable participants presented a wide spectrum of viewpoints, including those of issuers, retail and institutional investors, exchanges, and sell-side firms with expertise in trading less-active securities.

I found the observations of firms that focus on smaller companies to be particularly enlightening. They emphasized that the relative lack of liquidity in the stocks of smaller companies not only affects investors when they trade, but also detracts from the companies' prospects for success. Illiquidity hampers them in many areas, including in their ability to raise additional capital, obtain research coverage, engage in mergers and acquisitions, and hire and retain personnel.[1]

A potential initiative to address illiquidity, which was discussed at length at the Roundtable, is the Department of the Treasury's recommendation in its Capital Markets Report to allow issuers of thinly-traded securities to suspend unlisted trading privileges for non-listing exchanges, while continuing to allow off-exchange trading in these securities as a means to maintain competition among trading venues.[2]

To be clear, I recognize the inherent trading volume challenges in thinly-traded securities. The goal, however, is not to significantly increase the volume in these stocks; it is to identify pragmatic steps that could make it easier for buyers and sellers to find each other and consummate trades in this segment of the market.

Many panelists at the Roundtable raised concerns that the consolidated market data distributed through the NMS plans, known as "core data," may be no longer sufficient for them to trade competitively in today's markets.

I have asked our Division of Trading and Markets staff to explore this issue, including considering whether primary listing exchanges should develop pilot programs that would al-

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low us, and market participants, to explore the effects of restricting unlisted trading privileges for certain classes of thinly-traded stocks.

Combating Retail Fraud

As we consider enhancements to equity market structure and regulation more generally, we must be ever focused on the long-term interests of our Main Street investors. Protecting investors is a core statutory obligation of the Commission. Last year's Roundtable on Combating Retail Investor Fraud was focused on regulatory measures aimed at protecting retail investors from fraudulent and manipulative practices, particularly with respect to microcap and digital asset securities.

The U.S. securities markets, like many other markets, historically have attracted fraudsters, often involving schemes related to the latest investment trends. Over the years, these schemes have targeted mining stocks, tech stocks, and, more recently, digital asset securities. And, all too often, they are perpetrated in our penny stock markets. While the Commission has engaged in a robust Enforcement-led response to suspected retail fraud, including bringing cases against scammers and seeking appropriate trading suspensions, I believe that more can be done.

As we consider enhancements to equity market structure and regulation more generally, we must be ever focused on the long-term interests of our Main Street investors.

As highlighted during the Roundtable, well-tailored regulatory measures, along with investor education efforts, can help better protect retail investors from fraudulent and manipulative schemes without adversely affecting capital formation or investor opportunity. To that end, we are actively reviewing disclosure rules and registration rules with an eye toward greatly reducing the opportunity for retail fraud.

A particular focus of mine is Rule 15c2-11. This rule was designed to ensure that broker-dealers have sufficient information to understand and evaluate securities that trade off-exchange, or "OTC," prior to publishing a quotation and also be in a position to provide this information to investors. At the Roundtable, however, panelists noted circumstances where the current operation of this rule may result in retail investors having little or no relevant information about a company.[3] I am concerned that these circumstances are an example of how uneven the information playing field can be for retail investors in this sector. I am particularly troubled by what I see—again said bluntly—as Rule 15c2-11 providing a significant exception to our disclosure rules for companies that (*i*) have not provided *any* recent information or (*ii*) have conducted a reverse merger—*e.g.*, a larger private company merging into a smaller or "shell" public company—and the post-merger company has no relevant public information available.

I have asked our Division of Trading and Markets staff to prepare promptly a recommen-

dation to the Commission to update our rules to address these information issues, which experience tells us can be fertile ground for fraud and may be unnecessary to facilitate capital formation.

I also have a heightened level of concern for very low priced stocks known as penny stocks. These stocks, traded in the over-the-counter market, seem to have a special gravitational pull for fraudsters looking to take advantage of retail investors hoping for outsized returns. So, I have also asked staff to review the sales practice requirements relating to penny stocks within Exchange Act Rule 15g-9 and the definition of "penny stock" within Exchange Act Rule 3a51-1. Again, I am sure that *more* can be done to help prevent fraud and manipulation in penny stocks.

Market Data and Market Access

The third and final Roundtable in 2018 addressed another area where a review is needed—market data and market access. It is clear that technology has shifted this regulatory landscape in fundamental ways since the adoption of Regulation NMS.

We currently have what can be generally described as a two-tiered system of market data and market access in the U.S. equity markets. There are the consolidated public data feeds distributed pursuant to national market system plans jointly operated by the exchanges and FINRA. And there are an array of proprietary data products and access services that the exchanges and other providers sell to the marketplace. The second set, the proprietary data products, generally are faster, more content rich, and more costly than the consolidated data feeds.

Many panelists at the Roundtable raised concerns that the consolidated market data distributed through the NMS plans, known as "core data," may be no longer sufficient for them to trade competitively in today's markets.[4] Several panelists noted that, given the centralized infrastructure of core data, it could no longer be considered timely in today's high-speed markets, and that the content of core data may not provide some key information necessary to trade optimally.[5] Some panelists went further and asserted that they did not believe that core data was sufficient for brokers to achieve best execution for their customers.[6] These panelists included institutional investors and the brokers who serve them. Institutional investors, such as mutual funds and pension funds, represent millions of individual investors who rely on institutions to help them participate in the U.S. equity markets. The market data concerns raised by institutional investors and their brokers therefore implicate the interests of Main Street investors.

I believe that we should explore whether core data needs to be upgraded to better meet the needs of investors and market participants in today's modern markets

Retail brokers also expressed concerns about market data at the Roundtable. They argued that the fee structure for core data, including the definition of a non-professional user, im-

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poses costly administrative burdens on retail customers and their brokers.[7] The burdens cited include the requirements for retail customers to qualify as non-professional users and for retail brokers to prove the non-professional status of their customers.[8]

I believe that we should explore whether core data needs to be upgraded to better meet the needs of investors and market participants in today's modern markets, and to ensure that it better facilitates Exchange Act objectives. Accordingly, I have asked staff in our Division of Trading Markets to develop recommendations that would consider the concerns raised about core data and the potentially underlying causes that were highlighted during the Roundtable. I expect that, among other things, these recommendations will look to update and upgrade the content and infrastructure of core data.

More specifically, the recommendations may address the following:

- At the Roundtable, panelists stated that core data currently only includes the National Best Bid and Offer and top-of-book data[9] and is measurably slower than certain proprietary data. How can we help ensure that core data evolves along with the broader market ecosystem?
- Does the current governance model of the NMS Plans that oversee the core data systems[10] provide an appropriate level of transparency regarding market data and market access, including the associated revenues and costs?[11] Can the current governance model and transparency regime be improved? And if so, how?
- And finally, should we consider introducing greater competitive forces into the dissemination of core data than are currently possible with a centralized processor infrastructure and, if so, how?

Conclusion

To close, I think it is evident that each of the three Roundtables from last year—in the spirit of the Treasury's core principles reports—raised and framed important issues that require review. Last year, I ended my equity market structure remarks by asking for investor and securities industry engagement on the issues. I was gratified that you in fact did so engage last year, and your help greatly contributed to our success in moving equity market structure forward in 2018. I ask for your continued engagement this year, and, with your help, I am confident that we will continue to move our equity market structure forward in 2019 and beyond.

ENDNOTES:

[1]*See, e.g.,* Transcript of Roundtable on Market Structure for Thinly-Traded Securities (April 23, 2018), at 21-22 (Adam Epstein, Third Creek Advisors LLC) ("As a result of my firm's work with dozens of exchange-listed small cap companies over the last eight years, I see what I would characterize as the insidious nature of illiquidity on a day to day basis. And I use the word insidious because small cap trading illiquidity affects considerably more than capital formation. Trading illiquidity gravely impacts the ability for small cap companies to garner and retain research coverage. Trading

illiquidity gravely impacts mergers and acquisitions in the small cap ecosystem. Trading illiquidity gravely impacts the ability for small cap companies to hire and actually retain great employees."), *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/thinly-traded-securities-rountable-042318-transcript.txt.

[2]Several Roundtable panelists supported this approach, with some suggesting going even farther and considering whether Regulation NMS rules should be eliminated in this segment of the market. *See, e.g., Id.* at 89 (Brian Harkins, CboeBZX) ("So I think competition has got to drive innovation, and as I said it, I'll throw it out there, let's consider being open minded around Reg. NMS and potentially even revoking NMS for these names.")

[3]*See, e.g.,* Transcript of Roundtable on Regulatory Approaches to Combatting Retail Fraud (September 26, 2108), at 99 (Yvonne Huber, FINRA) ("I think under certain circumstances, piggyback eligibility should be taken away, such as in the reverse merger scenario, where there has been a completely different—a complete shift in the business line of a company, a complete change in ownership, a complete change in officers and directors. That's essentially a new company and it probably doesn't make sense in that space to allow piggybacking to continue."), *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/retail-fraud-round-roundtable-092618-transcript.pdf.

[4]*See, e.g.,* Transcript of Day One of Roundtable on Market Data and Market Access (October 25, 2018) ("Day One Transcript"), at 136 (Simon Emrich, Norges Bank Investment Management) ("What we find is the use cases for SIP data over the years has just decreased, has decreased substantially. . . . So,for the brokers, as has been mentioned before, the brokers can't really be competitive for our sort of trading just using the SIP. They need to have the full depth of book."), *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102518-transcript.pdf.

[5]*See, e.g., id.* at 125 (Adam Inzirillo, Bank of America Merrill Lynch) ("So the key difference between proprietary and the SIP feeds is the ability to build a depth of book across all markets. The nature of the SIPs, the nature of the locations of the SIPs introduce unavoidable latency effects."); 127-128 (Mark Skalabrin, Redline Trading Solutions) ("[T]hese customers cannot be competitive with the SIP. And there are two main reasons that have been talked about. One is latency, the geographic latency. . . And then as also has been mentioned, there's a series of content that exists in the direct feeds, some depth in orders and imbalances and odd lots and other things, that provide valuable information in how to make decisions in trading applications. So, a smart order router who wants to get a hit rate for their clients to take their orders and effectively fill them need the direct feed information."); 224 (Jamil Nazarali, Citadel) ("Well, I wouldn't say the SIP is just for eyeballs. But I would say that having the SIP is not enough. Right? For a number of reasons. You know, we talked about odd lots, we talked about depth of book. And we also talk about speed.").

[6]*See, e.g., id.* at 65-66 (Mehmet Kinak, T. Rowe Price) ("But as far as brokers having a choice of whether or not they can use the SIP or direct feeds, that doesn't exist. There is no choice there. If a broker is routing using SIP data, they are not routing my flow. . . . If I'm slower than the other person, I lose. That's it. That's the fraction of time we're talking about. So, when someone says, hey, from a commercial enterprise, it makes sense for you to use a faster system over a slower system—no. This is a best execution obligation. We are obligated to try and produce best execution on every single order that we have. If our brokers are not aligned in that manner to use the most direct, the fastest, the most robust feeds they can get their hands on, then we will trade with someone else."); 198-199 (Joseph Wald, Clear-

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pool Group) ("Clearpool and other broker-dealers are compelled to purchase exchanges' proprietary data feeds, both to provide competitive execution services to our clients and to meet our best execution obligations due to the content of the information contained in the proprietary data fees as well as the latency differences between them, which are major and important considerations for brokers.").

[7]*See, e.g., id.* at 134 (Jeff Brown, Charles Schwab) ("But, you know, at the end of the day things aren't free. And when you hear the exchanges talk about there's a free lunch for retail, that just doesn't exist. People pay for it. Our firm has to cover that. And Matt makes a great point that the contracting with the SIP providers is so arcane and full of these distinctions. . . . So there needs to be a real hard look at that whole structure."); Transcript of Day Two of Roundtable on Market Data and Market Access (October 26, 2018) ("Day Two Transcript"), at 196-197 (Marcy Pike, Fidelity Investments) ("For folks that aren't familiar with the way it works, there is a whole cottage industry that's been set up around being able to navigate and interpret exchange policies and regulations for how you use the data. Most large brokerage firms or asset managers that are consuming this data have significant staffs that are counting and reporting the usage of this data. . . . There is a whole group of folks that have entered into the industry to help facilitate audits for the exchanges, third parties that they will, in some cases, hire to help them with the auditing process. . . . And if the end game here is to get data out to Mr. and Mrs. 401(k), to the individual investor, I really think we should be rethinking, the whole administration, on what it takes for firms to be able to deliver that data."), *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/roundtable-market-data-market-access-102618-transcript.pdf.

[8]*See, e.g.,* Day One Transcript at 111-112 (Matt Billings, TD Ameritrade) ("For retail investors to receive real-time SIP data they are put through multiple steps. . . . The retail client, by default, according to the plans, is considered professional and must prove themselves otherwise. For Main Street investors who open a small business account, a mom or pop shop, they probably would be shocked to find out that they are considered professionals and must pay $92 across all three tapes per month to access real-time consolidated data. . .").

[9]For example, orders smaller than 100 shares are not available, market depth is not available, and auction imbalance information is generally not available.

[10]Some of the governance concerns articulated at the Roundtable were perceived conflicts of interest and a lack of diverse representation on the operating committees that oversee the NMS Plans.

[11]Many panelists emphasized that they lacked basic facts about market data and market access and that this precluded their ability to evaluate both consolidated and proprietary market data and market access and their respective fee structures. *See, e.g.*, Day Two Transcript at 230-237 (opening statement of Bill Conti, Goldman Sachs); 237-238 (opening statement of Melissa Hinmon, Glenmede Investment Management); 239-241 (opening statement of Rich Steiner, RBC Capital Markets).

SEC/SRO UPDATE:

SEC PROPOSES TO EXPAND "TEST-THE-WATERS" MODERNIZATION REFORM TO ALL ISSUERS; FORMER BIG FOUR AUDIT FIRM EXECUTIVE AND FORMER PCAOB EMPLOYEE CONVICTED OF WIRE FRAUD; SEC ADOPTS RULES TO IMPLEMENT FAST ACT MANDATE TO MODERNIZE AND SIMPLIFY DISCLOSURE

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SEC Proposes to Expand "Test-the-Waters" Modernization Reform to All Issuers

On February 19, the U.S. Securities and Exchange Commission (SEC) voted to propose an expansion of the "test-the-waters" modernization reform that, if adopted, would allow all issuers and any person acting on the issuer's behalf—not just emerging growth companies (EGCs) and including investment company issuers—to communicate about potential offerings with certain categories of potential investors at an earlier stage in the process than is currently permitted.[1]

These communications would be exempt from restrictions imposed by Section 5 of the Securities Act of 1933 on written and oral offers prior to or after filing a registration statement and would be limited to investors who are, or reasonably believed to be, qualified institutional buyers (QIBs) or institutional accredited investors (IAIs)

The proposed rule would be non-exclusive. As a result, issuers could rely on other Securities Act communications rules or exemptions when determining how, when, and what to communicate related to a contemplated securities offering.

Under the proposed rule:

- there would be no filing or legending requirements;
- test-the-waters communications may not conflict with material information in the related registration statement; and
- issuers subject to Regulation FD would need to consider whether any information in a test-the-waters communication would trigger disclosure obligations under Regulation FD or whether an exemption under Regulation FD would apply.

In the press release, the SEC indicated that this proposal was part of a larger effort to facilitate capital formation by increasing flexibility and establishing a cost-effective means for evaluating market interest before incurring the costs associated with such an offering. The SEC also noted that the proposed rule aligns with steps taken in 2017 by its Division of Corporation Finance to extend the ability to

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initially submit certain filings in draft, non-public form from EGCs to all issuers.

Comments on the proposed rule are due by April 29, 2019.

Former Big Four Audit Firm Executive and Former PCAOB Employee Convicted of Wire Fraud

On March 11, the U.S. Attorney for the Southern District of New York announced in a press release that the former national managing partner for audit quality at a Big Four audit firm, and a former employee of the Public Company Accounting Oversight Board (PCAOB) were convicted of wire fraud charges.

The charges came in connection with the pair's scheme to defraud the PCAOB by obtaining, disseminating, and using confidential lists of which of the Big Four firm's audits the PCAOB would be reviewing so that the firm could improve its performance in PCAOB inspections.[2]

The PCAOB, a private nonprofit corporation overseen by the SEC, is responsible for carrying out regular inspections of audits performed by registered accounting firms. As part of the inspection process, the PCAOB chooses a selection of audits performed by an accounting firm for a closer review. Until shortly before an inspection occurs, the PCAOB does not disclose which audits are being inspected, or the focus areas for those inspections, because it wants to ensure that an auditor does not perform additional work or modify its work papers in anticipation of an inspection. Following the completion of an inspection, the PCAOB issues an inspection report containing any negative findings or "comments" with respect to both the specific audits reviewed and the accounting firm more generally, which then are passed on to the SEC.

Prosecutors claimed that in or about 2015, the Big Four firm in question was engaged in efforts to improve its performance in PCAOB inspections, including but not limited to recruiting and hiring former PCAOB personnel. At the time, the former executive was head of the firm's national office, which was broadly responsible for the quality of the firm's audits and the firm's performance in PCAOB inspections. The former PCAOB employee was an inspections leader at the PCAOB, who was obligated to keep confidential the PCAOB's nonpublic information.

Prosecutors claimed the former PCAOB employee leaked confidential information about upcoming PCAOB inspections to people at the firm, including the former executive, between 2015 and 2017. The former executive and others at the firm then agreed to launch a stealth program to "re-review" the audits that had been selected, allowing the firm to strengthen its work papers and fare better in inspections.

Prosecutors also charged two other employees at the firm, both former PCAOB staffers who joined the firm during the period in question, with taking part in the scheme by bringing confidential information with them to their new jobs. Both pleaded guilty before trial. Prosecutors claim the former PCAOB employee was angling to make a similar move to the private sector, providing his resume to a

firm employee involved in the scheme and seeking her assistance in helping him acquire employment at the firm.

The former executive was convicted of one count of conspiracy to commit wire fraud and three counts of wire fraud. The former PCAOB employee was convicted of one count of conspiracy to commit wire fraud and two counts of wire fraud. The conspiracy to commit wire fraud and wire fraud charges each carry a maximum prison term of 20 years.

SEC Adopts Rules to Implement FAST Act Mandate to Modernize and Simplify Disclosure

On March 20, the SEC announced that it had voted to adopt amendments to modernize and simplify its disclosure requirements applicable to public companies, investment advisers, and investment companies.[3] The amendment reflects several of the recommendations in the SEC Staff's November 2016 Report on Modernization and Simplification of Regulation S-K mandated by Section 72003 of the Fixing America's Surface Transportation (FAST) Act[4], and the staff's broader review of the SEC's disclosure system. Among other things, the amendments:

- Revise rules or forms to update, streamline, or otherwise improve the SEC's disclosure framework by eliminating the risk factor examples listed in the disclosure requirement and revising the description of property requirement to emphasize the materiality threshold;
- Update rules to account for developments since their adoption or last amendment by eliminating certain requirements for undertakings in registration statements;
- Simplify disclosure or the disclosure process, including proposed changes to exhibit filing requirements and the related process for confidential treatment requests and changes to Management's Discussion & Analysis that would allow for flexibility in discussing historical periods; and
- Incorporate technology to improve access to information by requiring data tagging for items on the cover page of certain filings and the use of hyperlinks for information that is incorporated by reference and available on EDGAR.

The amendments relating to the redaction of confidential information in certain exhibits will become effective upon publication in the Federal Register. The rest of the amendments will be effective 30 days after they are published in the Federal Register, except that the requirements to tag data on the cover pages of certain filings are subject to a three-year phase-in, and the requirement that certain investment company filings be made in HTML format and use hyperlinks will be effective for filings on or after April 1, 2020.

ENDNOTES:

[1]*See* SEC Press Rel. No. 2019-14 (Feb. 19, 2019), *available at* https://www.sec.gov/news/pressrelease/2019-14.html (press release) and SEC Rel. No. 33-10607 (Feb. 19, 2019), *available at* https://www.sec.gov/rules/proposed/

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2019/33-10607.pdf (proposing release).

[2]*See* Former KPMG Executive And Former PCAOB Employee Convicted Of Wire Fraud For Scheme To Steal And Use Confidential PCAOB Information (March 11, 2019), *available at* https://www.justice.gov/usao-sdny/pr/former-kpmg-executive-and-former-pcaob-employee-convicted-wire-fraud-scheme-steal-and.

[3]*See* SEC Rel. No. 2019-38 (March 20, 2019), *available at* https://www.sec.gov/news/press-release/2019-38.

[4]*See* the Fixing America's Surface Transportation (FAST) Act, *available at* https://www.congress.gov/114/bills/hr22/BILLS-114hr22enr.pdf.

FROM THE EDITORS

Elon Musk v. the SEC, Redux: The Tweets Keep Coming

Last September, electric car maker Tesla Inc. and its CEO Elon Musk agreed to a settlement with the Securities and Exchange Commission concerning Musk's controversial habit of making off-the-cuff comments on Twitter regarding the fortunes of the company he founded.

As part of the settlement, Musk agreed to seek approval from Tesla about what was allowable communication of important information concerning the company, which presumably included any future tweets.

Well, that goodwill apparently didn't last very long. Indeed, the SEC has requested that U.S. District Judge Alison Nathan find Musk in contempt of the agreement and noted that the CEO never sought approval for a single tweet related to Tesla after agreeing to do so.

The SEC cited a tweet Musk sent on February 19 to his more than 24 million Twitter followers that Tesla would build around 500,000 cars this year—which Musk later corrected to say that the "annualized production rate at end of 2019" would be around 500,000 cars, or roughly 10,000 cars per week, but that "deliveries for year still estimated to be about 400k."

Like so much in the world of securities litigation and enforcement, the issue hangs on the meaning of *material*. Musk contends he agreed to have Tesla only approve his comments that contained material information, and not surprisingly, he also contends that he gets to decide what is material. In this case, Musk argued in a court filing responding to the SEC contempt request that because the production numbers (albeit, the *correct* production numbers) were already public, that his "single, immaterial" tweet was in compliance with the settlement, and that the SEC's push to find him in contempt infringed on his free speech.

Needless to say, the SEC has a somewhat more expansive view of what constitutes material information, especially when it comes from the CEO of a company. In its filing, the SEC stated that it was "stunning to learn that. . . Musk had not sought pre-approval for a single one of the numerous tweets about Tesla he published in the months since the court-ordered pre-approval policy went into effect."

Legal watchers suggested the SEC had numerous options to deal with Musk, including seeking a higher fine (both he and Tesla already were levied fines of $20 million each), issuing further restrictions on Musk's social media communications, and even seeking to remove him from running the company.

Musk and the Tesla Board of Directors also faces a lawsuit from shareholders who contend that Musk's "unchecked misstatements on Twitter" have harmed the company. The suit was filed March 8 in the Delaware Court of Chancery by the Laborers' District Council and Contractors' Pension Fund of Ohio.

With the back-and-forth still raging as we go to press, *Wall Street Lawyer* will be keeping an eye on this situation.

—Gregg Wirth, Managing Editor

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