Current Developments in Securities Law

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Crypto Coin & Initial Coin Offerings

- Currencies simultaneously are a medium of exchange, store of value and unit of account
  - Crypto not widely used in exchange
  - Crypto value is very volatile, even with so-called stable coins
  - Crypto not used in financial records
- Ergo crypto coin is not a currency

Crypto Coin & Initial Coin Offerings

- In July 2017, SEC issued a Report of Investigation in the matter of Slock.it
- Slock.it sponsored tokens issued through a decentralized autonomous network (DAO)
- DAO tokens would be sold to investors to raise assets which were to be invested in projects
- Investors would be entitled to a portion of the earnings of these projects or could sell the tokens on a secondary market

Crypto Coin & Initial Coin Offerings

- Unfortunately hackers stole a third of the assets between the sale of the tokens and investment in projects
- SEC views such tokens a securities which fall under SEC regulation
- SEC relied on the U.S. Supreme Court decision in *SEC v. Howey,* 328 U.S. 293 (1946) and opined that DAO tokens were investment contracts, because they represented:
  - An investment of money
  - In a common enterprise
  - With the expectation of profit
  - From the effort of others

Crypto Coin & Initial Coin Offerings

- On September 11, 2018, SEC settled an enforcement matter with Crypto Asset Management LP (CAM) in which it alleged that CAM
  - Made false statements to the effect that it was the "first regulated crypto asset fund in the United States"
  - Raised more than $3.6 million dollars in an unregistered non-exempt public offering of Crypto Asset Fund, LLC (CAF) securities
  - Engaged in the business of investing, holding and trading certain digital assets that were investment securities having a value exceeding 40% of the value of CAF
  - Earned incentive and management fees pursuant to the terms of a management agreement with CAF

Crypto Coin & Initial Coin Offerings

- In its settlement with the SEC, CAM agreed to
  - The issuance of a SEC Cease and Desist Order
  - A censure
  - A penalty of $200,000 for violating the registration requirements of the Securities Act of 1933, as amended (1933 Act), the Investment Company Act of 1940, as amended (1940 Act) and the Investment Adviser Act of 1940, as amended (Advisers Act)

Crypto Coin & Initial Coin Offerings

- On September 11, 2018, the SEC settled an enforcement proceeding, against TokenLot LLC, a self-described "ICO Superstore" alleging that it had acted as an unregistered broker dealer in violation of the Securities Exchange Act of 1934 , as amended (1934 Act)
- TokenLot was found to have received orders from more than 6,100 retail investors and handled more than 200 different digital tokens which the SEC argued were securities
- In its settlement with the SEC, TokenLot agreed to
  - Disgorge $471,000 and interest in the amount of $7,929
  - Retain a third party to destroy its remaining inventory of digital assets
  - The individuals controlling TokenLot agreed to a penny stock bar and an investment company prohibition

Crypto Coin & Initial Coin Offerings

- The Financial Industry Regulatory Authority (FINRA) has filed an enforcement action against an associated person of a FINRA member firm for marketing an unregistered cryptocurrency security called "Hemp Coin" and making fraudulent statements
- Hemp Coin was represented as the "world's first currency to represent equity ownership" claiming that each coin represented 0.10 share of Rocky Mountain Ayre, Inc.
- FINRA alleged that the mining of 81 million Hemp Coins involved the sale of 81 million unregistered securities

Crypto Coin & Initial Coin Offerings

- A September 11, 2018 order issued in *United States v. Zaslavskly,* a criminal case in U.S. District Court for the Eastern District of New York, stated that simply labeling an investment opportunity as a virtual currency or cryptocurrency does not transform an investment contract into a currency
- A jury can decide whether cryptocurrencies were investment contracts and therefore securities under the *Howey* test

Developments in Capital Raising

- On May 24, 2018 the Economic Growth, Regulatory Relief and Consumer Protection Act was enacted which directed SEC to revise Regulation A to make issuers that are subject to Section 13 or Section 15(d) of the 1934 Act eligible to use this exemption
  - Change may be more significant to small-cap companies that are subject to the 1934 Act reporting requirements and whose securities are traded over-the-counter
  - Small-cap companies that opt for a Tier 2 offering under Regulation A and will not need to comply with state securities laws

Developments in Capital Raising – SEC Regulation D

- Effective January 20, 2017, SEC raised the maximum limitation on offerings relying on Rule 504 from $1 million in a 12 month period
- Effective May 22, 2017, SEC repealed Rule 505 which it believed, in context of the changes to Rule 504 and Regulation A, was no longer a viable method for issuers to raise capital
- Effective January 20, 2017, SEC amended Rule 504 to include a bad actor disqualification. This action completed the harmonization of bad actor disqualifications applicable to offerings made in reliance on Regulation A, Regulation D and Regulation Crowdfunding

Developments in Capital Raising – Rule 147 and 14AA

- Effective April 20, 2017, SEC substantially revised Rule 147 and adopted a new exemption in Rule 147A
- Rule 147 and Rule 147A both relate to Section 3(a)(11) of the 1933 Act which provides a self-executing exemption from registration with the SEC of "any security which is part of an issue offered and sold only to persons resident with a single state or territory where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business with the state or territory" (Intrastate Exemption)
- Rule 147 sets forth a non-exclusive "safe harbor" with respect to the availability of the Intrastate Exemption

Developments in Capital Raising – Rule 147

- The prior iteration of Rule 147 required an issuer to meet multiple tests to determine it they were "doing business in the state"
- Now an issuer need only meet **one** of the following requirements:
  1. The issuer derived 80% of its consolidated gross revenues from the operation of a business or of real property located in or from the rendering of services within the state
  2. The issuer, as of the most recent semi-annual fiscal period prior to the initial offer of securities in any offering or subsequent offering under Rule 147, derived at least 80% of its assets and those of its subsidiaries on a consolidated basis located within the state
  3. The issuer intends to use and uses at least 80% of the net proceeds from sales made under Ruler 147 in connection with the operation of a business or of real property, purchase of real property located in or the rendering of services within the state
  4. A majority of the issuer's employees are based in the state

Developments in Capital Raising – Rule 147

- Prior to its recent revision, Rule 147 limited resales to residents of another state for a period of nine (9) months from the date of the last sale in the offering
- The revisions changed the limitation period for resales to residents of another state to a period of six (6) months from the date of sale which is similar to the integration safe harbor under Regulation D

Developments in Capital Raising – Rule 147A

- New Rule 147A is an exemption intended to accommodate offerings made in reliance on state crowdfunding exemptions that have been adopted by over 35 state jurisdictions
  - Available to any issuer except an investment company that is registered or required to be registered under the 1940 Act. However, the issuer at all times when making offers or sales must be a person resident and doing business in the state where *all of the sales* are made.
- In contrast, Rule 147 requires all *offers and sales* to be within the state. This important distinction exempts crowdfunding websites that may be accessed by out-of-state individuals

Developments in Capital Raising – Rule 147A

- Under Rule 147A, the issuer will be deemed to be the resident in the state where it has its principal place of business. This requirement is different from Rule 147 which requires the issuer to be organized under the laws of the state in which it has its principal place of business
- Therefore, a business organized under Delaware law but having its principal place of business in New Jersey will be exempt under 147A if all sales are made to residents in New Jersey
- The criteria for "doing business in the state" are the same under 147A as under Rule 147

Developments in Case Law – Disgorgement

- In *Kokesh v. SEC* (decided June 5, 2017), the U.S. Supreme Court issued a unanimous decision that held that the five (5) year statue of limitations in 28 U.S.C. §2462 applied to applications by the SEC to a court for disgorgement as permitted by Section 21 of the 1934 Act
- Thus, it appears that the court held that disgorgement is not an equitable remedy, but rather, serves a punitive role and not a compensatory one
- The decision has thrown doubt upon SEC cases where disgorgement occurred that was outside the five (5) year statute of limitations
- At this time, only the SEC's civil injunctive remedies remain unconstrained by a statute of limitation

Developments in Case Law – Whistleblowers

- Dodd-Frank added section 21F(h) of the 1934 Act which prohibits an employer from discharging, demoting, suspending, threatening, harassing, directly or indirectly, or in any other manner discriminating against a whistleblower in the terms and conditions of employment because of any lawful act done by a whistleblower in connection with:
  - Providing information to the SEC
  - Initiating, testifying in or assisting in any investigation or judicial or administrative action of the SEC based upon or related to such information
  - Making disclosures that are required or protected under the Sarbones-Oxley Act of 2002 (SOX), the 1934 Act, Section 1513 of Title 15 of the U.S. Code and any other law, rule or regulation subject to the jurisdiction of the SEC

Developments in Case Law – Whistleblowers

- Under Section 21F(a)(6) of the 1934 Act, the term "whistleblower" means any individual who provides, or two or more individuals acting jointly, who provide information relating to a violation of the securities laws to the SEC in a manner established by the SEC
- The anti-retaliation provisions in Section 21F(h)(1)(A)(iii) of the 1934 Act appear to cast broader net of protection by protecting "disclosures that are required or protected under the Sarbanes-Oxley Act of 2002, the Securities Exchange Act of 1934 ... And any other law, rule or regulation subject to the jurisdiction of the Commission"
- Question posed: Is providing information to the SEC a prerequisite to receiving anti-retaliation benefits of Section 21F(h) of the 1934 Act?

Developments in Case Law – Whistleblowers

- In *Asadi v. G.E. Energy (USA), LLC*, 20 F.3d 620 (5th Cir. 2013), the U.S. Circuit Court of Appeals for the Fifth Circuit held that, based on the definition of "whistleblower" in Section 21F(a)(6), the anti-retaliation provisions of Dodd-Frank were available only to those who provide information to the SEC
- However, in *Berman v. Neo@Oglivy*, 801 F.3d 145 (2d Cir. 2015), the U.S. Circuit Court of Appeals for the Second Circuit stated that the "arguable tension" between the definition of "whistleblower" in Section 21F(a)(6) and the relevant anti-retaliation provision rendered Section 21F ambiguous and deferred to the SEC's position that Congress did not intend to limit the availability of Dodd-Frank's anti-retaliation provisions

Developments in Case Law – Whistleblowers

- The U.S. Supreme Court granted certiorari in *Digital Realty Trust v. Somers* to resolve the divergence among the circuits
- In a unanimous opinion dated February 21, 2018 the Court held that Dodd Frank prohibits retaliation against whistleblowers only if the suspected wrongdoing was reported to the SEC
  - Whistleblowers who report internally within their employer to their supervisor or to a whistleblower "hotline" or to other civil or law enforcement agencies cannot avail themselves of the anti-retaliation provisions of Dodd-Frank. They must pursue private actions under SOX or state law provisions
  - SOX entitles whistleblowers to reinstatement, back pay and special damages; Dodd-Frank allows reinstatement and double back pay but not special damages

Developments in Case Law – Deferred Prosecution

- In a deferred prosecution agreement, the U.S. Department of Justice (DOJ) will file criminal charges against a corporation in court
- Later, it may enter into an agreement to defer further prosecution against the corporate defendant in recognition of significant efforts made by the defendant with respect to remediation or improvements in its compliance program or a bona fide pledge of such efforts
- The agreement will contain "milestones" which the corporation must meet within specified time periods and, if met, DOJ will petition the court to withdraw all charges with prejudice
- The DOJ and the court retain jurisdiction and, should the defendant fail to meet the milestones, DOJ may recommence the criminal prosecution

Developments in Case Law – Deferred Procescution

- In *United States v. Fokker Services, B.V.*, 818 F.3d 733 (DC Cir. 2016) the U.S. Court of Appeals for the District of Columbia held that, due the constitutional separation of powers, federal courts could not refuse to approve a deferred prosecution agreement because it disagreed with the DOJ
- Subsequently, in *United States v. HSBC Bank USA, N.A.*, 863 F.3d 125 (2d Cir. 2017) the U.S. Court of Appeals for the Second Circuit held that the monitor's report which details corporate compliance with the agreement cannot be disclosed by a federal court because it was not a judicial document

Developments in Case Law – FCPA

- In *United States v. Hoskins*, a the U.S. Court of Appeals for the Second Circuit held on August 24, 2018 that the Foreign Corrupt Practices Act (FCPA) does not impose conspiracy liability on a foreign national who is not an agent, employee, officer, director or shareholder of a U.S. issuer or domestic concern unless that person commits a crime within the territory of the United States
  - A foreign national who works for a non-US company that does not issue securities in the U.S. and who is not within the territorial limits of the U.S. cannot be charged with conspiracy to violate the FCPA or aiding and abetting a violation of the FCPA
  - Court cited *RJR Nabisco, Inc. v. European Community*, 136 S.Ct. 2090 (2016), as a judicial presumption against extraterritoriality of U.S. Laws indicating that this presumption remains active even within the context of the FCPA

Developments in Case Law – FCPA

- Hiring and basis for hiring staff may be deemed a violation of the FCPA as constituting a "thing of value"
- BNY Mellon was alleged to have provided coveted student internships to family members of foreign government officials associated with a sovereign wealth fund
  - These applicants did not go through BNY's existing competitive internship program which had stringent hiring standards and multiple interviews
- SEC argued that BNY Mellon maintained few specific controls around the hiring of relatives of customers including foreign nationals
- BNY Mellon paid $4.8 million to settle the alleged FCPA violation

Developments in Case Law – FCPA

- JPMorgan Chase and its Hong Kong subsidiary allegedly focused their hiring on individuals who, in the bank's own words, could have "directly attributable linkage to business opportunity"
- The bank argued that hiring well-connected employees was routine in China and that these hires fell into a grey area of the FCPA
- The SEC and DOJ argued that JPMorgan increased its hiring of candidates based on referrals from Chinese leaders or senior bankers who were in a position to refer business
- JPMorgan Chase agreed to a deferred prosecution agreement and paid a fine of $264 million to settle the FCPA charges

Developments in Case Law – SEC Rule 10b-5

- In *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), the U.S. Supreme Court held that the anti-fraud provisions of Section 10(b) of the 1934 Act and SEC Rule 10b-5 applied only to "domestic transactions" rejecting a former ruling by the U.S. Court of Appeals for the Second Circuit which ruled the provisions applied if the wrongful conduct passed either the "effects test" or the "conduct test"
  - Under the effects test, the wrongful conduct would need to have a substantial effect in the U.S. or upon U.S. citizens
  - Under the conduct test, the wrongful conduct would need to occur within the U.S.

Developments in Case Law – SEC Rule 10b-5

- The Dodd-Frank Act reversed *Morrison* and reinstated the "effects test" and the "conduct test" for extraterritorial application of the 1933 Act, 1934 Act and Advisers Act but only over any action or proceeding brought by the SEC or United States alleging a violation of the anti-fraud or prohibited practices provisions of these statutes
- Post-*Morrison,* the U.S. Court of Appeals of the Second Circuit determined that, to meet the "domestic transaction" test, a plaintiff must allege that the purchaser incurred irrevocable liability within the U.S. to deliver the security, including the passing of title to shares within the U.S.
- The Second Circuit's "irrevocability test" has been adopted by the Third Circuit and most recently by the Ninth Circuit in *Stoyas v. Toshiba Corp.* decided on July 17, 2018
- Simply, a plaintiff must plausibly allege that the purchaser incurred irrevocable liability in the United States to take and pay for a security or that the seller incurred irrevocable liability within the United States to deliver a security

Developments in Case Law – SEC Rule 10b-5

- *Stoyas* involved transactions in American Depository Receipts (ADR) of Toshiba stock. The ADRs which were the subject of this case were not listed on a national securities exchange but were traded in the over-the-counter market in the U.S.
- Section 10(b) of the 1934 Act applies to securities registered on a national securities exchange or any security not so registered. Therefore the ADRs fall into the second category of securities covered by Section 10(b)
- The court focused on whether the transaction was a "domestic" transaction under *Morrison* and, by allowing the plaintiff leave to amend the complaint, it appears the court would view ADRs bought and sold in the over-the-counter market in the U.S. to meet the "domestic transaction" test of *Morrison* under the "irrevocability" test of the Second Circuit

Developments in Case Law – Sophisticated Purchasers

- In May 2018, the U.S. Court of Appeals for the Second Circuit overturned a federal securities fraud conviction of Jesse C. Litvak who was accused of misstating the price at which his firm acquired residential mortgage-backed securities and then resold them to persons who the court determined where sophisticated investors
- Because these sophisticated investors used computer models to value securities and each side knew the types of mortgages backing the securities, the sophisticated investors could assess future returns on the value of the mortgages themselves and what any trader said about the purchase price should not affect the underlying valuation
- This case seems to opine that, although a material misstatement may be uttered, evidence that such material misstatements were made in the context of transactions with sophisticated purchasers may be insufficient to base a criminal securities fraud conviction

Developments Relating to Financial Intermediaries and Financial Exploitation of Seniors

- The Senior Safe Act of 2018 was enacted on May 24, 2018 to encourage a collaborative effort by regulators, financial firms and legal organizations to prevent senior financial abuse by providing immunities for reporting under the U.S. Bank Secrecy Act
- Under certain circumstances, depository institutions, credit unions, investment advisors, broker-dealers, insurance companies, insurance agencies and transfer agents will not be liable for disclosures made in good faith and with reasonable care to state and federal law enforcement and regulatory and local agencies responsible for providing adult protective services in connection with reporting suspected exploitation of a senior citizen

Developments Relating to Financial Intermediaries and Financial Exploitation of Seniors

- Immunity is achieved only where the persons reporting the suspected exploitation work for a covered institution in a supervisory, compliance or legal function and, before the time of disclosure, received training relating to identifying and reporting suspected exploitation of a senior citizen
- Provisions of the law are not mandatory but motivational

Developments Relating to Financial Intermediaries and Financial Exploitation of Seniors

- FINRA Rule 2165 on Financial Exploitation of Specified Adults was adopted in February 2017 and applies to all broker-dealer firms registered with FINRA
- The rule permits a member firm to place a temporary hold on disbursement of funds or securities from the account of specified customers where there is a reasonable belief of financial exploitation of these customers
- Member firms also are required to make a reasonable effort to obtain a name and contact information for a trusted contact person for each customer who the broker-dealer could contact concerning the customer

Developments Relating to Financial Intermediaries and Financial Exploitation of Seniors

- A "specified person" is a natural person age 65 and older or a natural person age 18 or older who the member firm reasonably believes has a mental or physical impairment that renders the individual unable to protect their own interests
- The temporary hold will expire not later than 15 business days after the date the temporary hold was placed unless otherwise terminated or extended by a state regulator or agency of competent jurisdiction or a court of competent jurisdiction
- If an internal review by the broker-dealer of the facts and circumstances supports the member's belief of exploitation that is planned, occurring or has already occurred, the hold may be extended for an additional 10 business days

Developments Relating to Financial Intermediaries and Financial Exploitation of Seniors

- If a hold is placed, an oral or written notification, along with an email, must be provided within two business days therefrom that a temporary hold has been placed and the reasons therefor
- The notification must be sent to all parties authorized to transact business on the account and to the trusted contact person
- However, if any such person is unavailable or is suspected of financial exploitation of the specified person, notification does not need to be sent

Developments Relating to Financial Intermediaries and Financial Exploitation of Seniors

- Effective January 13, 2018, the Pennsylvania Department of Banking and Securities (Department) adopted a rule governing use of senior specific certifications and professional designations in connection with the offer, sale or purchase of securities or the provision of investment advice
- A violation of this rule by a registered agent, broker-dealer, investment adviser or investment adviser representative would form a basis for the Department to take action against the registrant's license for engaging in dishonest or unethical practices in the securities business or taking advantage of a customer

Developments Relating to Financial Intermediaries and Financial Exploitation of Seniors

- The use of a senior specific certification or professional designation is prohibited if:
  1. The certification or designation has not been earned or the person is ineligible to use the certification or designation
  2. The certification or designation infers that the individual has a level of occupational qualification obtained through education, training or experience that the person does not have
  3. The certification or designation is nonexistent or the individual has self-certified

Developments Relating to Financial Intermediaries and Financial Exploitation of Seniors

4. The certification or professional designation has been obtained from an organization that
   a) Is primarily engaged in the business of instruction in sales or marketing, or both;
   b) Does not have reasonable standards or procedures for assuring the competency of its designees or certificate holders;
   c) Does not have reasonable standards or procedures for monitoring and disciplining its designees or certificate holders for improper or unethical conduct; or
   d) Does not have reasonable continuing education requirements for its designees or certificate holders to maintain the designation or certification

Re-Write of Pennsylvania Securities Regulations

- The most significant change affecting securities offerings is the repeal of 10 Pa. Code, Ch. 206.020 that a tax opinion or discussion of tax aspects prepared by an independent attorney, certified public accountant or other professional be filed with the Department in connection with a proposed offering of limited partnership interests by means of a registration by qualification under Section 206 of the 1972 Act
- This repeal removes a significant impediment to issuers organized as limited partnerships that desire to make a Pennsylvania-only public offering of limited partnership interests

Re-Write of Pennsylvania Securities Regulations

- 10 Pa. Code, Ch. 210.010 has been amended to reflect revisions made in Section 210 of the 1972 Act which expanded retroactive registration to any issuer that had an effective registration statement under Section 205 (registration by coordination) or 206 (registration by qualification) of the 1972 Act
- It is unclear if there is an additional fee due if the issuer has not already paid the maximum filing fee permitted under the 1972 Act

Re-Write of Pennsylvania Securities Regulations

- The regulation at 10 Pa. Code, Ch. 211.010 relating to notice filings for federally covered securities has been amended to permit the Department to issue an order requiring the filing of documents filed with the SEC for a Tier 2 offering of securities under SEC Regulation A
- With respect to a Tier 1 offering under SEC Regulation A, Section 203(u) of the 1972 Act exempts any offer or sale of a security in an offering exempt under Section 3(b)(2) of the Securities Act of 1933, subject only to a notice filing with the Department or filing of documents filed with the SEC

Re-Write of Pennsylvania Securities Regulations

- The Department has also adopted at 10 Pa. Code, Ch. 302.071 the NASAA model rule relating to exempting solicitors of investment advice from registration as investment adviser representatives if the solicitor:
  1. Delivers a disclosure document relating to cash payment for client solicitation set forth in 10 Pa. Code, Ch. 404.012
  2. Provides only impersonal investment advisory services as defined in SEC Rule 206(4)-3(d)(3) under the Advisers Act
  3. Is not subject to certain "bad actor" disqualifications described in Section 305(a) of the 1972 Act

Re-Write of Pennsylvania Securities Regulations

- A new regulation has been added at 10 Pa. Code, Ch. 304.071 which requires investment advisers registered with the Department to establish, implement and maintain written procedures relating to a business continuity and succession plan and lists several topics which such procedures must cover
- For investment advisers who are sole proprietors, this regulation imposes a legal obligation to formalize succession and continuity arrangements for their firms

Re-Write of Pennsylvania Securities Regulations

- To implement the change made to Section 305(a)(ix) of the 1972 Act by Act 52 of 2014, 10 Pa. Code, Ch. 305.019(b) was amended to provide a ten (10) year statute of limitations applicable to action taken by the Department to deny, suspend, condition, revoke any application or registration of, or censure, a broker dealer, agent, investment adviser or investment adviser representative for engaging in dishonest or unethical practices in the securities industry or taking unfair advantage of a customer

Re-Write of Pennsylvania Securities Regulations

- It is worth noting that 10 Pa. Code, Ch. 305.019(a) states that "Every person registered under section 301 of the 1972 Act (which includes broker-dealers, agents, investment advisers and investment adviser representatives) is a **fiduciary** (emphasis added) and shall act primarily for the benefit of its customers and observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business"

Thank you!

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