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Industry Update

SEC Chairman Gives Remarks on Capital Formation

On August 29, 2018, SEC Chairman Jay Clayton spoke about key SEC capital formation initiatives at the 36|86 Entrepreneurship Festival in Nashville, Tennessee.

During his speech, Chairman Clayton discussed how innovation and financing "hot spots" were highly concentrated, with California, Massachusetts and New York receiving more than 78% of all equity financing for venture capital-backed companies in the first quarter of 2018, despite those three states accounting for just 20% of the U.S. population. The Chairman stated that he wants to ensure regulation of capital formation "enables capital to flow" to other regions of the United States while remaining committed to investor protection.

Chairman Clayton stated that he believes that the SEC should focus on assisting small businesses throughout the country to "access capital to grow, create new jobs, and, in turn, provide investors, including our Main Street investors, expanded investment opportunities." He noted the discussions the SEC has had with companies at "different stages of the growth cycle," in order to better understand the challenges, including regulatory challenges, these companies face when raising capital.

Chairman Clayton next took a few moments to discuss initial coin offerings. In discussing the SEC's approach to distributed ledger technology, digital assets, and initial coin offerings, Chairman Clayton stated that the SEC's efforts are guided by the following key principles the SEC has followed for decades: "(1) embrace new technologies that cut costs and provide new investment opportunities while (2) continuing to require that our retail investors have access to the material information necessary to make an investment decision, including the key risks involved, as well as other fundamental protections."

Chairman Clayton encouraged those interested in raising capital to "consider whether they are engaging in an offer or sale of securities" which would place the activities "squarely in the SEC's jurisdiction." The Chairman additionally encouraged interested individuals to review Bill Hinman's speech regarding the SEC's approach to evaluating whether a digital asset is a security, and to reach out to the staff of the Division of Corporation Finance for further assistance, noting the division's recent hiring of a Senior Advisor for Digital Assets and Innovation to help "coordinate efforts in this area across the agency."

Chairman Clayton next emphasized the efforts that the SEC has undertaken in the last sixteen months with the goal of fostering capital formation, and what efforts the SEC's upcoming regulatory agenda will feature. In this respect, he discussed how the SEC has moved to reduce regulatory burdens on pre-IPO and smaller public companies, while upholding and, in certain cases, enhancing, investor protections. The Chairman stated that this focus is important given the rising trend of emerging companies choosing to remain private, meaning that investors receive less wholesome disclosure, in addition to the lack of opportunity for retail investors to "invest directly in high-quality private companies."

Chairman Clayton then discussed three categories of SEC actions in the public company space:

1. Scaled Disclosure Framework for Smaller Companies: Chairman Clayton acknowledged that one-size regulatory plans do not work for all public companies, especially for smaller companies post-IPO. He noted that in June 2018, the SEC expanded the number of companies that qualify as smaller reporting companies ("**SRCs**"), a category established in 2008 to "provide regulatory relief for smaller companies by allowing them to provide scaled disclosures, which, in turn, reduces compliance costs." According to the Chairman, the new definition of SRC allows a company to qualify as an SRC if its public float is less than $250 million (previously the threshold had been $75 million). Additionally, he noted that the definition was expanded to capture companies with less than $100 million in annual revenues if they have either no public float or a public float that is less than $700 million. In addition to these change, the Chairman stated that the SEC is currently in the process of exploring the market structure for the securities of smaller, more thinly traded securities, with a goal of improving secondary market liquidity for such smaller companies.

2. Disclosure Modernization and Simplification: Chairman Clayton reviewed the SEC's October 2017 proposed amendments to "streamline rules and forms that public companies use to provide information to investors, and also incorporate technology to improve access to information" that reduces registrants' costs. According to the Chairman, the SEC staff is currently working on its final recommendations in this respect. He then discussed proposed amendments intended to "simplify and update financial disclosures," in addition to the final rules adopted to "simplify and update disclosures by eliminating requirements" that were outdated, overlapping or duplicative.

3. Guidance From the SEC's Division of Corporation Finance Helpful to the IPO Process: The Division of Corporation Finance expanded the Jumpstart Our Business Startups Act's (the "**JOBS Act**") confidential review process to all first-time registrants and newly public companies conducting IPOs and offerings within one year of an IPO. The Chairman stated that this offers registrants "more control over their offering schedules and limits their exposure to market volatility and competitive harm," without reducing investor protection. He also discussed the Division of Corporation Finance's guidance clarifying what financial information is required when submitting draft registration statements and how this has allowed registrants to avoid the time and expense of preparing and filing interim financial information.

Chairman Clayton next discussed how the SEC's upcoming agenda will continue to encourage capital formation. He began by considering the SEC's regulation of public companies. He stated that he expects the SEC to review the triggering threshold of Section 404(b) of the Sarbanes-Oxley Act of 2002, which requires certain registrants to provide an auditor attestation report on internal control over financial reporting. He considered how the associated costs may divert significant capital without meaningful benefit. Chairman Clayton stated that he believes in a scaled approach that is more appropriate for smaller reporting companies and reiterated that one size does not fit all.

The Chairman also mentioned that the staff is reviewing the category of companies who can "test the waters" in raising capital under the JOBS Act, which permits emerging growth companies to "engage in communications with certain potential investors prior to or following the filing of a registration statement for an IPO." This allowance, according to Chairman Clayton, benefits investors and shareholders as companies can better determine the appropriate time to make an offering and can more effectively size and price the offering.

Chairman Clayton then considered capital formation vis-à-vis private companies, the importance of nurturing growth and maturation, and how small businesses have more options through the intrastate exemption, Regulation Crowdfunding, Regulation D and Regulation A. The Chairman noted that since these rules have gone into effect, "small businesses have conducted over 900 offerings that reported raising more than $90 million collectively using Regulation Crowdfunding," in addition to the 300-plus offerings that reportedly raised over $1 billion pursuant to Regulation A. He mentioned that the SEC has recently expanded the exemption that permits private companies to issue securities to employees, consultants and advisors as compensation. Additionally, the Chairman encouraged the public to provide feedback on how to improve rules governing the "gig economy," as alternative work arrangements may cause individuals not to be considered "employees," meaning that they would not be eligible to "receive securities as compensatory awards under our current exemption." Chairman Clayton followed up by proposing certain considerations for the future, including: (1) the level of complexity of the current exemptive framework for issuers and investors, and whether this framework can be rationalized and streamlined; (2) limitations on who can invest in certain offerings and other limiting criteria; and (3) whether more can be done to allow issuers to transition from one exemption to another and then to a registered IPO.

Chairman Clayton concluded by stating that "[t]he SEC is committed to efforts to develop a regulatory framework that equally serves the neighborhood coffee shop that is looking to expand into a second location, the biotech startup looking to hire more scientists to cure cancer, the social media company looking to conduct its IPO, and the Main Street investor saving for their future."

- **See the Transcript**

Litigation

Regulators Step Up Enforcement on Crypto Firms

After a several month lull that led some to question the SEC's focus on crypto enforcement, early September saw a spate of enforcement activity involving crypto assets: several SEC enforcement actions, an SEC trading suspension order, the first FINRA cryptocurrency enforcement action, and a preliminary court decision consistent with the view that ICO tokens may be (and perhaps often are) securities. For further information on these enforcement activities, please see the September 13, 2018 article entitled **Regulators Step Up Enforcement on Crypto Firms** from Davis Polk's FinReg blog.

SEC Resolves FCPA Allegations Against U.S.-Based Investment Firm for Bribery of Qaddafi-era Libyan State-Owned Enterprises

On August 27, 2018, the SEC issued an order (the "**LM Order**") against Legg Mason, Inc. ("**Legg Mason**"), a Baltimore-based investment management firm, instituting and settling cease-and-desist proceedings for failing to devise and maintain sufficient internal controls to detect and prevent the use by a former subsidiary of Libyan intermediaries to bribe Libyan state-owned financial institutions in exchange for investment business.

According to the LM Order, between 2004 and 2010, Legg Mason, through Permal Group Ltd. ("**Permal**"), its former subsidiary, partnered with Société Générale S.A. ("**Société Générale**") to solicit business from Libyan state-owned financial institutions. Société Générale allegedly received funds from the Libyan state-owned financial institutions and directed portions of these investments into funds managed by Permal. In exchange for assistance in securing such investments, Société Générale paid certain Libyan intermediaries a "commission" based on the amount of the investment. The Libyan intermediaries, in turn, allegedly used portions of this "commission" to bribe high-level officials in order to secure further investments. Permal did not pay the Libyan intermediaries, but, according to the SEC, Permal employees were aware of the bribes paid by the Libyan intermediaries at the time and discussed the details of the scheme with Société Générale personnel.

Additionally, in 2008, a Permal employee accompanied a Libyan government official connected to the investments at issue to Boston, where Permal provided the official with a course in negotiations at a university, as well as luxury hotel accommodations and entertainment.

Ultimately, as a result of the scheme, Permal obtained seven investments and earned net revenues of approximately $31.6 million.

Based on the conduct described above, the SEC found that Legg Mason violated Section 13(b)(2)(B) of the Exchange Act, which requires the establishment and maintenance of an adequate system of internal accounting controls. The LM Order found that Legg Mason failed to establish and maintain adequate internal controls with respect to the use of brokers and intermediaries in emerging markets, including Libya, and did not take adequate steps to identify or mitigate the risks of bribery and corruption.

Legg Mason consented to the entry of the LM Order and admitted to the subject matter of the proceedings. In doing so, it agreed to cease and desist and to pay $34,502,494, of which $27,594,729 constitutes disgorgement and $6,907,765 constitutes pre-judgment interest. The LM Order notes that a civil penalty was not imposed due to the $32,625,000 criminal penalty imposed by the United States Department of Justice on June 4, 2018 for the same underlying conduct.

- **See a copy of the LM Order**

SEC Settles with Massachusetts Financial Services for $1.9M for Advertising Misstatements

On August 31, 2018, the SEC issued an order (the “**MFS Order**”) against Massachusetts Financial Services (“**MFS**”), instituting and settling cease-and-desist proceedings arising out of alleged material misstatements and omissions in MFS’s 2006-2015 advertisements. According to the SEC, MFS’s advertising material showed that MFS’s blended stock research ratings achieved superior hypothetical returns ratings without disclosing that some of the ratings came from retroactive, back-tested application of its ratings models. The Order states that MFS violated the Advisers Act “by publishing, circulating, and distributing advertisements that contained misleading statements of material fact.”

According to the MFS Order, from 2006 to 2015, MFS advertised to institutional clients and prospective institutional clients, financial intermediaries and consultants that its blended research strategies, which combined fundamental and quantitative stock ratings, could yield better returns over time than either fundamental or quantitative stock ratings alone. MFS’s advertisements purported to demonstrate this success by providing a hypothetical portfolio of stocks rated “buy” by MFS’s fundamental analysts and quantitative models. But, for the period from 1995-2000, MFS allegedly used back-tested quantitative ratings, and for the period of 2000-2003, some live and some back-tested ratings. According to the SEC, MFS failed to disclose that the quantitative models were back-tested and did not disclose the risk that such back-tested performance is not due to successful predictive modeling. The SEC further alleged that MFS’s advertisements falsely claimed its hypothetical portfolio was based on in-house quantitative stock ratings dating back to the mid-1990s, despite MFS not generating its own quantitative stock ratings until 2000.

The SEC also observed MFS’s failure to adopt and implement adequate policies and procedures to prevent false and misleading advertisements. The Order states that information about the back-tested quantitative ratings was not clearly and consistently communicated to MFS personnel responsible for preparing and reviewing advertisements and that compliance personnel were unaware of pertinent facts necessary to determining whether the advertisements complied with federal securities law.

MFS voluntarily discontinued its use of the misleading advertising in 2015, prior to the investigation, and the SEC did not make a finding of any financial loss to MFS clients. The SEC explicitly noted that, in accepting MFS's settlement offer, it had considered MFS's voluntary retention of a compliance consultant to comprehensively review MFS's written compliance policies and procedures with respect to its advertisements.

Based on the conduct described above, the SEC found that MFS violated Sections 206(2) and 206(4) of the Advisers Act, and rules 206(4)-1(a)(5) and 206(4)-7 thereunder. Without admitting or denying the charges, MFS agreed to pay a civil money penalty of $1.9 million, to cease and desist from future violations, and to be censured.

- **See a copy of the MFS Order**

SEC Settles with VSS Fund Management LLC and Its General Partner for Failure to Disclose Valuation Increase to Exiting Limited Partners in Buy-out

On September 7, the SEC issued an order (the "**VSS Order**") against VSS Fund Management, an investment adviser with approximately $767 million under management as of December 2017, and its managing partner and owner, Jeffrey T. Stevenson, for failing to disclose a potentially significant increase in valuation in its VS&A Communication Partners III private equity fund ("**Fund III**") to several limited partners seeking to exit that fund.

According to the SEC, in April 2015, several limited partners of Fund III spoke to their advisers, VSS and Stevenson, about their desire for a liquidity option that would allow them to exit the fund. VSS and Stevenson offered to purchase the limited partners' stakes in the company for cash at 100% of the 2014 audited net asset value of $33.9 million and expressed intent to close the Fund and conduct a distribution in-kind based on the 2014 NAV (the "**April 2015 Offer**"). The offer letter referenced the companies' declining EBITDA and "the recent down performance" of one of the portfolio companies. The VSS Investment Committee, of which Stevenson was a member, approved the cash offer.

Shortly thereafter, in May 2015, the VSS Investment Committee received preliminary fund valuations that indicated material increases in the Q1 2015 NAV. The SEC alleges that even though limited partners representing 90% of the limited partnership interests expressed their desire to accept the offer to purchase at the 2014 NAV, neither VSS nor Stevenson disclosed to the limited partners that the asset value and EBITDA of the fund had risen subsequent to the April 2015 offer. Instead, VSS notified the limited partners that Fund III would remain open in lieu of a distribution in-kind and that Stevenson's April 2015 offer still stood. By the end of May 2015, 80% of Fund III limited partners had accepted the offer, and the valuation change was never disclosed. In addition, the SEC alleges, VSS never sent the Q1 2015 financials to any of the limited partners of Fund III.

Based on the conduct described above, the SEC found that VSS violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibit advisers from making untrue or misleading statements of material fact, or to engage in fraudulent, deceptive, or manipulative practices. Without admitting or denying the charges, VSS and Stevenson agreed to pay a civil money penalty of $200,000, to cease and desist from future violations, and to be censured.

- **See a copy of the VSS Order**

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