Wolters Kluwer

When you have to be right

Legal & Regulatory US Whitepaper

Hot Topics in SEC Filings 2017: Regulatory Roll-backs, Fintech, Cyber, and Blue Sky Offerings

By Jay Fishman, J.D. and Mark S. Nelson, J.D.

Inside

Executive Summary

The Trump Administration has put federal securities regulation in a state of flux. Just this past February, President Trump signed a joint congressional resolution eliminating disclosure obligations for resource extraction issuers, followed by then-Acting SEC Chairman Michael Piwowar's call for new guidance on the conflict minerals rule. These efforts have complicated rule compliance for issuers.

Then there is the world of virtual currencies, which the Commission will mull when it reviews an order disapproving Bats BZX Exchange's proposal to list and trade shares issued by the Winklevoss Bitcoin Trust. The Commission also issued significant guidance regarding the status of initial coin offerings under federal securities laws. And affecting these and other securities matters is an ever-increasing number of cybersecurity breaches that is pushing the SEC (with its Regulation SCI) and the states to step up their efforts to protect investors' financial data.

Of course, virtual currency and cybersecurity matters had already caught the SEC's attention by the time President Trump took office, but his Administration's overall desire to deregulate the financial industry has begun to impact regulatory decision-making, rendering this an "exciting" time to pay close attention to the agency's treatment of these issues over the next four years. And there's another issue to ponder—the number of federal Regulation A and Rule 147/147A offerings that may result from the SEC's recent adoptions of Regulation A and Rule 147 amendments, and new Rule 147A, to relax decades-old regulatory restrictions on U.S. capital formation and economic growth.

This White Paper will discuss the latest developments on SEC disclosure roll-backs, emerging virtual currencies issues, cybersecurity, and Regulation A+ and Rules 147 and 147A.

Introduction

The specialized securities disclosures targeted for roll-backs either by Congress or agencies led by Trump Administration appointees have already had a dramatic impact on some reporting companies' filings. Other disclosure obligations remain in force but subject to complex agency guidance. The following sections explore how Congress was able to reverse the SEC's resource extraction issuers rule and explain the SEC's latest guidance for making conflict minerals disclosures. Debate continues about whether the securities laws are the proper locus for specialized, non-financial disclosures.

With respect to fintech and cybersecurity, the federal government generally, and the SEC in particular, remain in a state of regulatory evolution. The SEC has taken early steps to address Fintech and, while the agency has retained its aging disclosure guidance on cybersecurity, it has more aggressively surveyed key industry participants and brought some cyber-related enforcement actions.

The SEC's newly confirmed chairman, whose background includes capital formation, could significantly impact agency policies on all of these issues. The chairman also will be tasked with implementing existing capital formation innovations, such as the revamped Rule 147 and new Rule 147A, plus any new capital formation provisions that could be enacted by the 115th Congress.

Specialized disclosures

Congress and the Trump Administration moved quickly to disapprove the SEC's resource extraction issuers rule and the Commission's then-Acting Chairman, Michael Piwowar, directed the SEC's Division of Corporation Finance to issue updated guidance on the agency's conflict minerals rule. While the disclosure obligation regarding resource extraction issuers is gone, at least until the SEC revisits its rule, companies must navigate two sets of guidance regarding conflict minerals, although that too could change as the SEC staff continues to mull a recommendation for Commission action on conflict minerals.

Oil & gas disclosure rule disapproved. In mid-February, President Trump signed a joint congressional resolution that disapproved the SEC's resource extraction issuers rule. The Commission adopted the Dodd-Frank Act-mandated rule last summer, which, under the timing provisions of the Congressional Review Act, made the rule eligible for a second look by lawmakers.

This was the first time Trump had signed CRA legislation, although he said more CRA actions were planned, according to a transcript of the signing ceremony published by the White House. Trump had earlier pledged to "dismantle" the Dodd-Frank Act, but the disapproval resolution only nullifies the SEC's implementing rule and does not repeal the authority for the rule contained in Dodd-Frank Act Section 1504. The Republican-led effort to push the joint resolution through Congress emphasized the costs of the rule to businesses and the impact of foreign competition on U.S. firms. Democrats had emphasized the rule's anti-corruption goals.

The SEC's latest version of the resource extraction issuers rule was the product of a re-write following protracted court battles. Legislation to disapprove the rule passed Congress just as the White House was unveiling a series of executive orders and other memoranda directing reviews of the Department of Labor's fiduciary standard rule and a wide-ranging review of U.S. financial system regulations.

The revised resource extraction issuers rule applied broadly to payments that are "not *de minimis*," meaning one or a series of related payments of at least $100,000. The rule included exemptions for acquired companies and for exploratory activities, and it reiterated that the Commission could grant other case-by-case exemptions. The rule became effective September 26, 2016, and compliance was set to begin for fiscal years ending on or after September 30, 2018.

The SEC could issue a new resource extraction issuers rule, but that may be difficult to do because the CRA prohibits the adoption of a rule in substantially the same form as a disapproved rule without specific, new legislative authority. A group of Democratic senators urged the SEC to re-issue the resource extraction issuers rule in a form that aligns with similar rules in the E.U. and Canada. The senators also said that while they could accept the SEC once again taking a case-by-case approach to exemptive relief under the rule for country laws that ban certain disclosures, they argued that a blanket exemption approach would undermine the Dodd-Frank Act mandate.

The Trump Administration's regulatory roll-backs have leveraged the previously lightly used CRA. But as the number of CRA resolutions grows, some lawmakers seek to curb use of the CRA. Senator Cory Booker (D-NJ) and Rep. David Cicilline (D-RI) announced plans to introduce the Sunset of the CRA and Restore American Protections (SCRAP) Act (S. 1140; H.R. 2449). The bills would repeal the CRA and make it easier for federal agencies to re-issue rules disapproved under the CRA.

Conflict minerals guidance added complexity. New guidance from the SEC's Corporation Finance Division (CorpFin) provides that staff will not recommend enforcement if companies do not comply with the due diligence part of the conflict minerals rule. But this guidance may be more complex than it seems.

The Commission adopted the conflict minerals rule to implement Dodd-Frank Act Section 1502's mandate for the SEC to press companies to improve their handling of supply chains for tin, tantalum, tungsten, and gold. The rule applies to necessary conflict minerals sourced from the Democratic Republic of the Congo and adjoining countries. The DRC is at the heart of Africa's Great Lakes Region, which had for years endured conflict, including sexual- and gender-based violence, perpetrated by local armed groups who obtained funding through trade in conflict minerals.

The SEC's conflict minerals rule, like the resource extraction issuers rule, has been lauded by those seeking to advance human rights around the globe and criticized as a legislative and regulatory overreach by those who view securities regulation as traditionally focused on financial disclosures to investors. The Dodd-Frank Act mandate to inquire into conflict minerals supply chains also plays into recent trends for companies to voluntarily engage in environmental, social and governance reforms to satisfy various corporate constituencies.

Required conflict minerals disclosures are made on Form SD, which accommodates specialized disclosures, including conflict minerals disclosures for the now-defunct resource extraction issuers rule. The final conflict minerals rule created a complex set of inquiries that can result in varying degrees of compliance, including the filing of a conflict minerals report. Congress may still revisit the Dodd-Frank Act's authorization for the SEC's conflict minerals rule. Section 862 of the Financial CHOICE Act of 2017 (H.R. 10) would repeal Dodd-Frank Act Sections 1502 and 1504, the SEC's rulemaking authority for conflict minerals and resource extraction issuers, respectively.

Litigation ends—Three years ago, a three-judge panel of the D.C. Circuit Court upheld the bulk of the conflict minerals rule against a challenge under the Administrative Procedure Act and the Exchange Act. But that same panel faulted a narrow provision on freedom of speech grounds; the targeted provision was a vital component of the conflict minerals disclosure regime for the drafters of Dodd-Frank Act Section 1502. As a result, the D.C. Circuit further held:

> that [the applicable Dodd-Frank Act provision], and the Commission's final rule,…,violate the First Amendment to the extent the statute and rule require regulated entities to report to the Commission and to state on their website that any of their products have "not been found to be 'DRC conflict free.'"

In August 2015, the panel reheard the case and reached the same conclusion, albeit with one additional justification to conform its opinion to a related en banc D.C. Circuit decision applying the Supreme Court's commercial speech doctrine. The SEC chose to forgo appealing the conflict minerals decision to the Supreme Court. The district court has since issued its final judgment remanding the conflict minerals rule to the SEC.

> *New guidance from the SEC's Corporation Finance Division (CorpFin) provides that staff will not recommend enforcement if companies do not comply with the due diligence part of the conflict minerals rule.*

As a result, except for the portion held invalid by the courts, the SEC's conflict minerals rule remains in effect. But the agency's latest guidance likely increases the complexity of companies' decisions about how to comply with the rule.

New SEC guidance—In January, just weeks after President Trump took office, and nearly two months before the district court's final judgment, newly appointed then-Acting SEC Chairman Piwowar issued a statement reciting what he viewed as defects in the rule and recalling his personal experience visiting Africa as highlighting for him how those defects burden companies that must comply with the rule. Specifically, Piwowar directed SEC staff to mull whether existing guidance issued in April 2014 remained "appropriate" and, in the interim, if more guidance is needed.

Piwowar's statement also noted that the phased implementation of the conflict minerals rule would soon end and many smaller companies would have to comply. Large companies, especially those with global business, already have several years' compliance experience and will have done much of the groundwork for the next round of disclosures due in May of each year. Companies with global business also will be planning to comply with newly approved European Union rules on conflict minerals that are binding as of January 1, 2021 (E.U. Council; E.U. Parliament).

Piwowar invited public comments on the question of new guidance. As of April 11, 2017, the SEC had received over 12,000 comments, mostly form letters, although the 284 individual comment letters run the gamut from urging repeal, expressing support, or recommending specific adjustments. Commenters include Amnesty International USA, which intervened in the conflict minerals litigation, and Stein Mart, Inc., Elm Sustainability Partners LLC, NYSE, and the Sustainability Accounting Standards Board.

CorpFin's April 2014 guidance addressed what a company should do in the event it is (is not) required to file a conflict minerals report. The existing guidance also left open the possibility that a company could voluntarily describe a product as "DRC conflict free" if it also provided an independent private sector audit, but no company would be required to describe its products in this manner or as "DRC conflict undeterminable" or "not found to be 'DRC conflict free.'"

The April 2017 guidance on conflict minerals only addresses enforcement with respect to the due diligence efforts required by companies that must reach Item 1.01(c) of Form SD. Specifically, CorpFin will not recommend enforcement action to the Commission if a company only files the disclosures under Items 1.01(a) and (b) of Form SD. Those provisions require a registrant to conduct a reasonable country-of-origin inquiry and to disclose on Form SD its determination based on the RCOI and to briefly describe the RCOI it undertook.

Piwowar issued a separate statement related to the new guidance in which he said the due diligence requirement's purpose was "to enable companies to make the disclosure found to be unconstitutional." He later summed up his request for additional CorpFin guidance: "In light of the foregoing regulatory uncertainties, until these issues are resolved, it is difficult to conceive of a circumstance that would counsel in favor of enforcing Item 1.01(c) of Form SD." The acting chairman also confirmed that he has asked SEC staff to prepare a recommendation for Commission action on the conflict minerals rule.

The April 2017 guidance makes no explicit reference to the April 2014 guidance, nor does it explicitly say the prior guidance is superseded. The two January 2017 statements by CorpFin and Piwowar, as well as the April 2017 CorpFin statement, speak only of "whether the 2014 guidance is still appropriate and whether any additional relief is appropriate in the interim" and of public comments on "the desirability of additional guidance or whether relief under the rule is appropriate."

New and Existing Guidance Compared

	April 2014 Guidance	April 2017 Guidance
Reasonable country of origin inquiry	• Disclose reasonable country of origin inquiry. • Briefly describe the inquiry.	• Still requires filing of disclosures per Form SD, Items 1.01(a) and (b).
Due diligence	• Describe due diligence.	• CorpFin will not recommend enforcement if company does not file due diligence disclosures per Form SD, Item 1.01(c).
Product within Form SD Items 1.01(c)(2) or (c)(2)(i)	• No need to identify product as "DRC conflict undeterminable" or "not found to be 'DRC conflict free.'" • Disclose (i) facilities used to produce the conflict minerals; (ii) country of origin of the minerals; and (iii) efforts to determine the mine or location of origin.	
Voluntary election to describe product as "DRC conflict free" in conflict minerals report	• Guidance does not require this. • If elect voluntary description, obtain IPSA (IPSA not otherwise required).	

Source: Adapted from (i) Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule, Keith F. Higgins, Director, SEC Division of Corporation Finance (April 29, 2014); and (ii) Updated Statement on the Effect of the Court of Appeals Decision on the Conflict Minerals Rule, SEC Division of Corporation Finance (April 7, 2017).

Significantly, CorpFin cautioned that its new guidance is subject to renewed action by the Commission, but only states the division's view about enforcement, and does not state a "legal conclusion" about the conflict minerals rule. The new CorpFin guidance may raise more questions than it answers for some companies, especially those well into disclosure preparation for the upcoming deadline. Since the conflict minerals rule became effective, some companies have gone beyond what they have been expected to disclose under SEC guidance, including obtaining IPSAs. Companies subject to the conflict minerals rule will need to make individualized decisions about what to file in their next Forms SD, which are due May 31. Overshadowing these decisions is the potential for liability under Exchange Act Section 18 for misleading statements in documents filed with the Commission.

Although it will take time to evaluate the latest set of conflict minerals filings, it appears that despite the SEC's revised guidance, some of the bellwether companies opted to make roughly the same disclosures as they have done in prior years. Apple Inc, for example, filed its conflict minerals report on April 5, well ahead of the May 31 deadline, and continued to assert that it employs modes of tracking its conflict minerals supply chains beyond what is legally required. Electronic components supplier KEMET Corporation filed its conflict minerals report along with an independent private sector audit report. Kemet's webpage on conflict minerals notes that the company is the world's largest user of tantalum, one of the 3TG minerals (tantalum, tin, tungsten, and gold) targeted by the conflict minerals rule. Intel likewise filed a conflict minerals report and obtained an IPSA.

How Do the Authorities Line Up?

Document	Status
Dodd-Frank Act Section 1502.	Statutory authority for SEC's conflict minerals rule. Still in force. Allows presidential directives for SEC to waive or revise rule for up to two years, or for termination of disclosure requirement.
SEC conflict minerals rule.	Still in effect. Rule remanded by U.S. District Court to Commission. Open question regarding whether the statute or the SEC rule required portion of rule held to violate First Amendment.
FAQ within Exchange Act Rules C&DIs: • **Questions 1-12 (May 30, 2013).** • **Questions 13-21 (April 7, 2014).**	Question (12) states that the failure to timely file a Form SD will not result in an issuer losing eligibility to use Form S-3. The FAQ notes that the Commission's partial stay and the April 29, 2014 CorpFin guidance may have superseded some of the items addressed in the FAQ.
CorpFin Guidance (April 29, 2014).	Extensive instructions on how to comply after first D.C. Circuit opinion upheld bulk of rule, but found part of rule violated the First Amendment.
Partial stay (May 2, 2014).	Conflict minerals rule partially "stayed pending the completion of judicial review, at which point the stay will terminate." Commission elected to forgo appeal to the U.S. Supreme Court; the district court remanded the rule to the Commission.
CorpFin Guidance (April 7, 2017).	Statement that CorpFin "will not recommend enforcement action to the Commission if companies, including those that are subject to paragraph (c) of Item 1.01 of Form SD, only file disclosure under the provisions of paragraphs (a) and (b) of Item 1.01 of Form SD."
Exchange Act Section 18.	Provides for private action alleging misleading statements in filed documents. States elements of action and defense, and gives court discretion to allocate costs and attorney's fees among parties. Action must be brought within one year of discovery of facts giving rise to suit and within three years after accrual. Form SD is filed per final conflict minerals rule (proposal required disclosure to be furnished as exhibit to annual report).

Source: Adapted from (i) Dodd-Frank Act Section 1502; (ii) SEC Release No. Release No. 34–67716 (August 22, 2012); (iii) Dodd-Frank Wall Street Reform and Consumer Protection Act Frequently Asked Questions, Conflict Minerals, issued May 30, 2013 and April 7, 2014; (iv) Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule, Keith F. Higgins, Director, SEC Division of Corporation Finance (April 29, 2014); (v) In the Matter of Exchange Act Rule 13p-1 and Form SD, Release No. 34-72079 (May 2, 2014) (order issuing partial stay); (vi) Updated Statement on the Effect of the Court of Appeals Decision on the Conflict Minerals Rule, SEC Division of Corporation Finance (April 7, 2017); and (vii); Exchange Act Section 18.

Revise, waive, terminate? In February, several media outlets and securities law blogs reported that the Trump Administration may be considering invoking the Dodd-Frank Act's revise or waive language regarding the conflict minerals rule based on a purported draft memorandum, but that possibility has not yet occurred. The Dodd-Frank Act permits the president to direct the Commission to revise-or-waive the conflict minerals rule for up to two years if the president transmits his determination that such action is in the U.S.'s national security interest and states the reasons for the determination. The Dodd-Frank Act also permits the president to terminate the conflict minerals disclosure requirement if he determines and certifies to Congress "that no armed groups continue to be directly involved and benefitting from commercial activity involving conflict minerals."

Spotlight on Piwowar; State Department request—Even before CorpFin issued its new conflict minerals guidance, Piwowar's direction to agency staff to review existing guidance had evoked concern from members of Congress. Senator Bob Menendez (D-NJ), joined by Sens. Elizabeth Warren (D-Mass), Brian Schatz (D-Hawaii), and Senate Banking Committee Ranking Member Sherrod Brown (D-Ohio), wrote to the SEC's inspector general to request an investigation into Piwowar's use of his powers as acting chairman. The senators questioned whether Piwowar's actions regarding the conflict minerals rule, the reopening of comments on the pay ratio rule, and new limits imposed on the enforcement division's subpoena authority were lawful and consistent with the SEC's mission.

Meanwhile, the State Department has asked "stakeholders" to comment on how the department and other agencies can best support responsible sourcing of conflict minerals. The department's notice observed that the U.S. "remains committed" to partnering with others to sever ties between armed groups in Africa's Great Lakes Region and the conflict minerals trade. Comments were due by April 28, 2017.

Since then, several dozen commenters have urged the State Department to take a range of next steps regarding conflict minerals reporting. Many commenters acknowledged imperfections in the conflict minerals rule, but still urged U.S. regulators to retain it. Other commenters noted the potential harm to the DRC from the existing conflict minerals rule and that such reporting is contrary to traditional financial reporting under the securities laws. One commenter suggested placing the compliance burden more squarely on upstream importers, smelters, and refiners, rather than on downstream entities, which may be many layers removed from the source of the minerals. Two commenters noted that cobalt should be added to the list of conflict minerals (Apple Inc., separate from the comment process, announced in a report that it had expanded its supply chain mapping to include cobalt).

Expanded confidential registration review availability

The SEC's Division of Corporation Finance announced that it will permit a much wider set of issuers to submit voluntary draft registration statements for confidential nonpublic staff review. A press release quoted Chairman Jay Clayton as suggesting that the expanded program could make U.S. securities markets more attractive. Previously, the SEC had implemented a system for emerging growth companies (EGCs) to make similar confidential draft submissions under Section 106 of the Jumpstart Our Business Startups (JOBS) Act, which added Securities Act Section 6(e) to allow these reviews. The newly expanded program began July 10, 2017.

An issuer who seeks to take advantage of the Division's expanded confidential draft submissions policy must submit a confirmatory cover letter and abide by the timing requirements for publicly filing the registration statement and nonpublic draft submissions.

The announcement detailed the requirements for invoking the new procedures. An issuer who seeks to take advantage of the Division's expanded confidential draft submissions policy must submit a confirmatory cover letter and abide by the timing requirements for publicly filing the registration statement and nonpublic draft submissions. The timing requirements mostly track those for EGCs, which must publicly file the initial confidential submission and any amendments 15 days (originally 21 days) before a road show.

Foreign private issuers also may take advantage of the confidential submission process. A foreign private issuer would follow the same procedures as for other types of issuers, although a foreign private issuer that is an EGC may follow the procedures for EGCs.

Public Filing Requirements

Filing Type	Cover Letter to Confirm Timing of Public Filing	Road Show	Effective Date
1933 Act IPOs/Initial Registrations	Yes	15 days before	15 days before
1934 Act §12(b) Initial Registration	Yes	N/A	15 days before
1933 Act Offering within 1 year of IPO or 1934 Act Section §12(b) Registration	Yes	N/A	48 hours before

Source: Adapted from Announcement of Division of Corporation Finance, "Draft Registration Statement Processing Procedures Expanded" (June 29, 2017).

The Division also said that while draft submissions should be "substantially complete," an issuer may omit financial information that it reasonably believes will not be required upon publicly filing the registration statement. The eased requirement tracks similar language for EGCs contained in Section 71003 of the Fixing America's Surface Transportation (FAST) Act.

Moreover, the Division will consider informal written requests made under Rule 3-13 of Regulation S-X to omit financial statements (consistent with investor protection). But Rule 3-13 also states the Commission may, by informal written notice, require an issuer to file additional or substitute financial statements to both ensure that a person's financial condition is adequately presented and for purposes of investor protection.

The Division also issued a set of FAQs to address numerous specific issues that may arise under the expanded draft submission process. For example, Questions 8 and 9 explain that draft submissions need not be signed, nor would all prior drafts need to be signed or include expert consents upon public filing. Question 16 states that a draft submission is not a "filing" for purposes of Securities Act Section 5(c). SEC staff comment letters with respect to draft submissions also will become public per Question 11. But Question 15 would deny test-the-waters communications available to EGCs to other types of issuers invoking the expanded program. Moreover, Question 13 clarifies that the draft submission process is off limits to asset-backed securities issuers.

Fintech: SEC puts brakes on trading of virtual currencies

Financial technology or fintech encompasses diverse digitally-driven products and services, including blockchain and other technologies associated with digital assets such as virtual currencies. The Commission already has concluded that certain Ethereum-based tokens are securities. Moreover, the Commission may weigh in on the listing and trading of virtual currencies now that the agency's Division of Trading and Markets, under its delegated authority, has disapproved a Bats BZX Exchange, Inc. proposed rule change to list and trade shares issued by the Winklevoss Bitcoin Trust.

Commodity-trust exchange-traded products. In disapproving the Bats proposal, the SEC staff noted that the applicable Exchange Act standards for the listing and trading of shares of commodity-trust exchange-traded products (ETPs) include, among other things, the requirement that the markets for the underlying commodity or derivatives on that commodity be regulated and that the exchange enter into surveillance sharing agreements with significant markets. The SEC's order said Bats could not achieve either of these requirements because the significant spot markets for bitcoin are unregulated.

A large portion of the SEC's order reviewed the nearly 60 comment letters received on the proposed rule change, many of which emphasized that bitcoin markets are often located overseas, can be illiquid, and may involve questionable practices, such as front-running, wash sales, and conflicts of interest regarding bitcoin mining.

The Winklevoss Bitcoin Trust's investment goal was to track the price of bitcoins on Gemini Trust Company's Gemini Exchange. With respect to regulatory oversight, the SEC said that, despite Bats's recitation of the CFTC's enforcement actions against Coinflip, TeraExchange, and Bitfinex, the CFTC registers spot markets only in limited instances, and the CFTC would not oversee Gemini Exchange. As for Gemini Exchange, the SEC noted that while public comments were unclear about how much bitcoin volume the exchange handled, it appeared to the SEC that Gemini Exchange's volume was a small part of the overall bitcoin market.

The SEC also found fault with a white paper submitted in support of another rule proposal because it failed to account for many aspects of bitcoin technology, such as a "hard fork" that could divide the underlying network into multiple blockchains. A footnote in the SEC's order noted that the Winklevoss Bitcoin Trust's registration statement had explained that the trust's custodian and sponsor would decide which of two resulting blockchains to use.

According to the Winklevoss Bitcoin Trust's registration statement, the choice would be made based on the "greatest cumulative computational difficulty"—i.e., "the total threshold number of hash attempts required to mine all existing blocks in the respective Blockchain, accounting for potential differences in relative hash difficulty"—within the 48 hours after a hard fork. This computation would serve as a basis for transacting and valuing bitcoins, although creation and redemption baskets would be halted for 24 hours before, and 48 hours after, a hard fork.

Bats has since asked the Commission to review the order disapproving of the exchange's proposal. Bats said in its petition for review that the order applied a new, "prescriptive" standard not required by the Exchange Act and argued that the potential for manipulation of bitcoin is not as great as the SEC staff suggested. Bats also urged the Commission to review the order because of bitcoin's novelty and the first-ever nature of the exchange's proposal.

Moreover, the SEC disapproved a similar rule change proposal by NYSE Arca, Inc. to list and trade shares of the SolidX Bitcoin Trust, and has instituted proceedings to determine if yet another proposal by NYSE Arca to list and trade shares of Bitcoin Investment Trust should be approved or disapproved. The SolidX disapproval focused on the same reasons cited for disapproving the Bats proposal: bitcoin markets are unregulated and the exchange could not obtain the needed surveillance sharing agreements. The SEC's order instituting proceedings regarding the Bitcoin Investment Trust proposal reviews numerous disclosures in the trust's registration statement regarding bitcoin markets and the operation of the trust.

The Forms S-1 filed by SolidX Bitcoin Trust and Bitcoin Investment Trust offer some additional details about the shares that would have been listed if the SEC had approved NYSE Arca's proposal. Moreover, the NYSE Arca and Bats proposals share many features, as do the three underlying bitcoin trusts (See comparison chart), although the proposals and the trusts differ in some important respects.

The Commission has since granted Bats's petition for review and provided the public a chance to comment on Bats's proposal to list and allow trading of shares in the Winklevoss Bitcoin Trust. Bats argued that the disapproval order should be reversed because the listing and trading of bitcoin trust shares proposed is consistent with the federal securities laws. Bats reiterated that the Winklevoss Bitcoin Trust would offer investors an entrée into bitcoin without the risks of direct investment in bitcoin while also addressing the SEC's concerns about manipulation of bitcoin markets.

For example, Bats said that the basket creation/redemption feature of the Winklevoss Bitcoin Trust is an arbitrage mechanism which can hold trading prices to levels near the intraday net asset value that, when coupled with the interconnectedness of the bitcoin market, offers a guard against manipulation, which Bats said "likely" would require global manipulation of the bitcoin market. Bats, like many of the several commenters, including Solid X Management LLC, whose SolidX Bitcoin Trust also is the subject of an SEC disapproval order regarding listing and trading of shares on NYSE Arca, leaned heavily on a paper (Supplement) commissioned by Solid X and authored by Craig Lewis, former SEC Chief Economist and Director of the Division of Economic and Risk Analysis, positing that bitcoin is less susceptible to false and misleading statements because it lacks material, nonpublic information typical of other investments like equities and, because of the continuous nature of bitcoin trading, it would be difficult to manipulate market opening and closing prices.

Bats also disputed the SEC's finding that the CFTC would not regulate bitcoin spot markets by noting the CFTC's anti-fraud and anti-manipulation authorities and the fact that the CFTC deemed bitcoin a commodity and has granted regulatory approvals (e.g., TeraExchange LLC; see also, LedgerX LLC, a bitcoin options exchange) and has engaged in related enforcement actions (TeraExchange LLC; Coinflip, Inc.; Bitfinex). Lastly, Bats asserted that the disapproval order imposed a new standard for approval that is inconsistent with prior similar proposals regarding commodity-trust ETPs. Specifically, Bats pointed to the order's discussion of surveillance-sharing agreements between the exchange and significant markets regarding trading of the underlying commodity (or derivatives) and that the underlying markets be regulated.

Solid X, while arguing on its own behalf, made many of the same claims about bitcoin markets as Bats. The firm said that to the extent the Commission alters the order of disapproval against Bats, the Commission should also reverse, modify, set aside or remand the order of disapproval against NYSE Arca's proposal. SolidX and several other commenters also noted the changed conditions in the bitcoin market arising from regulations imposed by the Peoples Bank of China that had the effect of reducing Chinese firms' share of the bitcoin trading volume and increasing the volume on U.S.- dollar-denominated exchanges. Moreover, although these commenters discuss generally how a bitcoin trust would decide what to do about a fork in the bitcoin blockchain, the comments predate the August 2017 fork in the bitcoin blockchain that produced a new virtual currency called Bitcoin Cash.

It is worth noting that the SEC held out some hope for exchanges seeking to list and trade virtual currency ETP shares by noting in the Bats disapproval that the agency could reconsider the status of bitcoin markets as they continue to develop. Moreover, the Commission has been asked by another trading venue to engage in rulemaking to more generally clarify the legal status of digital assets like bitcoin.

Additionally, both the SEC and the CFTC have established dedicated web pages addressing fintech issues. The SEC's fintech "spotlight" page features its November 2016 fintech forum, but also includes links to information about crowdfunding, distributed ledger technology, and automated investment advice. The CFTC recently announced its "LabCFTC" initiative, which includes a framework for CFTC outreach to fintech firms, and a program to improve the agency's use of fintech to achieve regulatory efficiencies that can enhance the agency's ability to carry out its core market oversight mission.

Initial coin offerings. The Commission issued a report of investigation in which it found that tokens offered to investors via an initial coin offering were securities. The report addressed questions the SEC had regarding a virtual organization known as The DAO, which used distributed ledger or blockchain technology to raise funds by selling coins or tokens in exchange for virtual currency. Significantly, the report did not deal with the question of whether the Investment Company Act might also apply to The DAO, but nevertheless suggested that similar virtual organizations should consider this and other possibilities under federal securities laws.

It is worth noting that the SEC held out some hope for exchanges seeking to list and trade virtual currency ETP shares by noting in the Bats disapproval that the agency could reconsider the status of bitcoin markets as they continue to develop.

The report also stated the Commission's decision to forgo an enforcement action related to The DAO. According to the report, that decision leaned heavily "…on conduct and activities known to the Commission at this time." A press release also explained that the decision not to pursue an enforcement action against The DAO resulted from the "facts and circumstances" of the matter but also suggested the Commission desired to send a warning to the initial coin offering industry about compliance with securities regulations.

A press release also explained that the decision not to pursue an enforcement action against The DAO resulted from the "facts and circumstances" of the matter but also suggested the Commission desired to send a warning to the initial coin offering industry about compliance with securities regulations.

But the Commission left open the possibility that some tokens or coins might fall outside the securities laws. Said the Commission: "Whether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction."

The DAO consisted of a German-based firm called Slock.it UG and its co-founders, who set up The DAO as a for-profit entity designed to hold assets to be determined via the issuance of DAO Tokens to investors for the purpose of using the resulting assets to fund projects. Projects were to be curated by persons selected by The DAO who would review and then "whitelist" projects for a vote by DAO Token holders. Projects were intended to produce a return on investment for DAO Token holders. DAO Tokens also could be traded on an online secondary market.

According to the Commission, The DAO was the brainchild of Slock.it's chief technology officer, Christoph Jentzsch, who explained the workings of The DAO in a white paper. The DAO was to operate using the Ethereum blockchain and the Ethereum (ETH or Ether) virtual currency. During a one-month period in Spring 2016, The DAO raised 12 million ETH (U.S. Dollar equivalent of $150 million) for sales of 1.15 billion DAO Tokens. At one point, after selling DAO Tokens but before funding any projects, an unknown third party hacked The DAO and stole one-third of its assets; The DAO implemented a work-around called a hard fork, which a majority of DAO Token holders approved, and was able to restore the stolen assets to a recovery site. The remedial steps allowed DAO Token holders to recover their investment by using the recovery site to obtain ETH for DAO tokens.

The Commission reasoned that DAO Tokens were securities under the familiar *Howey* test. The Commission's report cited the Supreme Court's re-worked version of the test: "[t]he 'touchstone' of an investment contract 'is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.'"

For one, the Commission said the exchange of ETH for DAO Tokens was a "contribution of value" that fell within *Howey*'s requirement that there be an investment of money. The report said The DAO was a common enterprise and that investors had a reasonable expectation of profits based on The DAO's for-profit structure and its promises of a return on investment from projects. But the fourth *Howey* element, that profits be derived from others' efforts would require more explanation.

The Commission said the fourth element was satisfied by the overarching control that Slock.it, its founders, and the curators had over The DAO (the curators had power to select projects to be whitelisted and could even decide if a vote would occur on a proposal to remove a curator). Slock.it and its founders also oversaw online forums and took remedial steps following the hacking episode. Moreover, DAO holders voting rights were limited to voting on projects vetted by the curators; voting power was further diluted by use of pseudonyms and dispersion. As a result, the report concluded that Slock.it, its founders, and the curators provided managerial efforts upon which DAO Token holders relied.

The Commission also took the opportunity to remind firms that they also must not only carefully navigate SEC rules on the registration of securities, but also must satisfy rules for the registration of exchanges or for exemptions from these rules such as for alternative trading systems. The Commission explained that The DAO could be subject to rules for exchanges (a footnote also said The DAO would likely not have qualified as a crowdfunder). The opening section of the report cautioned similar firms regarding application of U.S. securities laws and regulations:

> The automation of certain functions through this technology, "smart contracts," or computer code, does not remove conduct from the purview of the U.S. federal securities laws. This Report also serves to stress the obligation to comply with the registration provisions of the federal securities laws with respect to products and platforms involving emerging technologies and new investor interfaces (internal footnotes omitted).

Much as the Commission's report did, a joint statement by the SEC's Divisions of Corporation Finance and Enforcement reiterated that "security" is broadly defined under federal law. The Divisions said firms like The DAO, which leverage distributed ledger technologies, should consider whether they are issuing securities, determine if they need to register as an exchange or investment company, and whether persons offering related investment advice may be investment advisers. The joint statement also repeated the "facts and circumstances" language from the report regarding whether a specific investment is subject to federal securities laws, while suggesting that an enterprise's structure is also important.

The joint statement further mentioned the potential for fraud related to virtual organizations, a topic addressed in greater detail by a companion Investor Bulletin on initial coin offerings. In addition to providing background on virtual organizations, the bulletin noted that registered offerings of securities can be found by locating Forms S-1 on EDGAR. Information about crowdfunding issuers and their intermediaries (broker-dealers or funding portals) can be found on Forms C, which also are available on EDGAR. The SEC's Division of Investment Management provides searchable databases on investment advisers and investment companies. The Commission's report also had noted that an alternative trading system, which is exempt from certain requirements for exchanges, would notify the Commission of its activities under Regulation ATS by filing a Form ATS. Data on which firms have Forms ATS on file with the Commission can be found by visiting the webpage for the SEC's Office of FOIA Services.

Cybersecurity: SCI entities, enforcement, boards, and Blue Sky

The Securities and Exchange Commission adopted Regulation SCI to focus key market participants' attention on the resiliency of their cybersecurity-related systems and controls as part of the agency's modernization of its prior Automation Review Policy (ARP). But cybersecurity goes beyond just the entities and market activities subject to Regulation SCI. Instead, cybersecurity is a nearly omnipresent issue for companies that touches SEC enforcement, state regulation, company boards, and mergers and acquisitions.

Regulation SCI. The SEC's Regulation SCI contains basic requirements for SCI entities, including notice and review provisions, and key implementation dates. The SEC also published an FAQ and additional guidance on Regulation SCI. But securities regulations applicable in the cybersecurity setting go beyond Regulation SCI. Disclosure, enforcement, and corporate governance issues are discussed in more detail below.

What is an "SCI entity"?—Rule 1000 states that Regulation SCI applies to "SCI Entities" including: (i) SCI self-regulatory organizations; (ii) SCI alternative trading systems; (iii) plan processors; and (iv) exempt clearing agencies subject to ARP. The entities included in this definition are further defined by Regulation SCI and, in some instances, by other related securities regulations:

- "SCI self-regulatory organization"—The term includes national securities exchanges (regardless of volume) and self-regulatory organizations (SROs) such as FINRA and the MSRB. The term does not include certain notice-registered firms or registered limited purpose national securities associations.
- "SCI alternative trading system"—Rule 300(a) of Regulation ATS defines "alternative trading system" to mean any organization that provides a market place or facilities to bring together buyers and sellers of securities or for performing functions commonly performed by a stock exchange that does not set subscriber conduct rules (other than for trading on the organization) or disciplines subscribers only by excluding them from trading.

Regulation SCI imposes a volume threshold based on at least four of the prior six calendar months: (i) For NMS stocks either (A) 5 percent or more in any single NMS stock and one-quarter percent or more in all NMS stocks, or (B) one percent or more in all NMS stock; or (ii) five percent or more of the average daily dollar volume of non-NMS stock transactions reported to an SRO. The term does not include ATSs that trade only municipal securities or corporate debt. An SCI ATS has six months to comply with Regulation SCI after it reaches the volume threshold for the first time.

- "Plan processor"—Regulation SCI adopts the definition of "plan processor" in Rule 600(b)(55) of Regulation NMS: any SRO or securities information processor (SIP) acting as the exclusive processor of any facility contemplated by an effective NMS plan.
- "Exempt clearing agency subject to ARP"—Regulation SCI defines "exempt clearing agency subject to ARP" to mean an entity that has been exempted from Exchange Act

Section 17A by the Commission and whose exemption has conditions regarding ARP or any superseding regulation.

The CFTC also has adopted similar regulations (Exchange Final Rules; Clearing Final Rules). The Commission indicated that Regulation SCI would apply to entities that are dually registered with the SEC and the CFTC. These firms would comply with Regulation SCI with respect to securities activities and with the CFTC's regulations with respect to futures activities.

Safe harbor—Although Regulation SCI has no safe harbor for SCI entities, it does include a safe harbor for individuals. Rule 1001(b)(4) extends a safe harbor to an SCI entity's "personnel," which includes employees and non-employee contractors or consultants. Under the safe harbor, an individual is not deemed to have aided, abetted, counseled, commanded, caused, induced, of procured a Regulation SCI violation if the person reasonably discharged his or her duties under the SCI entity's policies and procedures, and the person was without reasonable cause to believe the policies and procedures were not maintained as required by applicable provisions of Regulation SCI in any material respect.

Compliance dates for SCI entities—Regulation SCI established a series of implementation milestones, all of which have now passed. But ATSs should be aware of the special timing requirements for entities that newly meet Regulation SCI volume thresholds.

Duties of SCI entities—Regulation SCI sets out numerous basic requirements detailing the ongoing obligations of SCI entities for their SCI systems. "SCI systems" is broadly defined to reference many forms of modern electronic technologies that, with respect to securities, directly support trading, clearance, and related activities. "Indirect SCI systems" are those systems for which a breach would be reasonably likely to pose a security threat to SCI systems.

"Critical SCI systems" fall into two categories. One set of SCI systems includes those that directly support: (i) clearing agencies' clearance and settlement systems; (ii) openings, re-openings, and closing on the primary listing market; (iii) trading halts; (iv) initial public offerings; (v) the provision of consolidated market data by SIPs; or (vi) exclusively listed securities. Another type of critical SCI system includes SCI entities that provide functionalities to securities markets for which alternatives are scarce and whose absence would materially impact fair and orderly markets.

Regulation SCI imposes many obligations on SCI entities regarding standards, personnel, testing, corrective action, and records.

- Operational capability/maintenance of fair and orderly markets—Rule 1001(a) requires the maintenance of written policies and procedures reasonably designed to ensure SCI systems and indirect SCI systems (regarding security standards) have the needed capacity, integrity, resiliency, availability, and security.
- Systems compliance—Under Rule 1001(b), an SCI entity must maintain written policies and procedures reasonably designed to ensure SCI systems comply with the Exchange Act, applicable securities regulations, and the entity's rules and governing documents.
- SCI personnel—Rule 1001(c) requires an SCI entity to maintain written policies and procedures for identifying, designating, and documenting its responsible SCI personnel.

Regulation SCI—Key Implementation Dates

Effective Date	February 3, 2015
General compliance date	November 3, 2015
Compliance date for ATSs newly meeting SCI ATS volume threshold	6 months after ATS meets Regulation SCI volume threshold for the first time
Compliance date for industry- and sector-wide SCI entity coordinated testing of BC-DR plans	November 3, 2016

Source: Adapted from SEC Release No. 34–73639 (November 19, 2014), 79 FR 72252 (December 5, 2014).

Notification of SCI events—Regulation SCI requires notification to the Commission of SCI events. "SCI event" means a systems disruption, compliance issue, or intrusion. Generally, dissemination of information about an SCI event under Rule 1002(c) must be done promptly to the SEC entity's members or participants who may be affected by the SCI event. Additional considerations apply to a "major SCI event," which the regulation separately defines.

Regulation SCI—Basic Requirements	
SCI review (Rule 1003(b)(1)).	Review SCI entity's compliance with Regulation SCI once each calendar year.
Penetration testing (Rule 1003(b)(1)(i)).	Do penetration test review at least once every three years.
SCI systems assessment (Rule 1003(b)(1)(ii)).	Assess SCI systems that directly support market regulation or market surveillance at a frequency determined by a risk assessment, but at least once every three years.
BC-DR testing (Rule 1004).	Designate SCI entity's members/participants to participate in testing of BC-DR plans at least once every 12 months. Coordinate testing of BC-DR plans on industry- or sector-wide basis with other SCI entities.
Corrective action (Rule 1002(a)).	An SCI entity, once its responsible SCI personnel have a reasonable basis to conclude an SCI event has occurred, must take corrective action that, at a minimum, mitigates potential harm to investors and market integrity while seeking to remedy the SCI event as soon as reasonably practicable.

Source: Adapted from SEC Release No. 34–73639 (November 19, 2014), 79 FR 72252 (December 5, 2014).

Regulation SCI—Notice, Reports, and Other Requirements		
Initial Notification of SCI event (Rule 1002(b)(1)).	Immediately	Form SCI not required (Exhibit 6 can include optional attachments)
Notification of SCI event (Rule 1002(b)(2)).	Within 24 hours	Form SCI (Exhibit 1)
Update of SCI event (Rule 1002(b)(3)).	Regular basis or upon reasonable Commission request	Form SCI not required (Exhibit 6 can include optional attachments)
Interim SCI event report (Rule 1002(b)(4)).	Within 30 days of occurrence	Form SCI (Exhibit 2)
Final SCI event report (Rule 1002(b)(4)).	5 business days after resolution and investigation by SCI entity closed if within 30 days of occurrence	Form SCI (Exhibit 2)
Quarterly report of no or de minimis impact SCI events (Rule 1002(b)(5)(ii)).	30 days after calendar quarter end	Form SCI (Exhibit 3)
Quarterly report of material system changes (Rule 1003(a)(1)).	30 days after calendar quarter end	Form SCI (Exhibit 4)
Supplemental report of material system changes (Rule 1003(a)(2)) (Report not required if information in Rule 1002(b) notification).	Promptly	
Report of SCI review with senior managers' response (Rule 1003(b)(3)). Review must be submitted to both the Commission and the SCI entity's board of directors.	60 days after submitted to SCI entity's senior managers	Form SCI (Exhibit 5)
Dissemination of information about SCI event (Rule 1002(c)). An exception exists if dissemination would compromise security or an investigation.	Promptly	
Major SCI events (Rule 1002(c)). "Major SCI event" means an SCI event that has had, or the SCI entity reasonably estimates would have, any impact on a critical SCI system or a significant impact on the SCI entity's operations or on market participants. **Practice tip:** The adopting release noted that dissemination to all members/participants is functionally equivalent to public dissemination because others will likely further disseminate it, often publicly. Moreover, Regulation SCI does not specify how an SCI entity should disseminate information, but the Commission suggested posting such information to the SCI entity's web page for "systems status alerts."	Promptly disseminate information to all of SCI entity's members of participants	

Source: Adapted from SEC Release No. 34–73639 (November 19, 2014), 79 FR 72252 (December 5, 2014).

Rule 1005 of Regulation SCI also imposes record-keeping requirements under which SCI SROs must keep related documents pursuant to Exchange Act Rule 17a-1, and non-SCI SROs must keep one copy of all relevant documents for five years. All entities subject to Regulation SCI must promptly furnish requested documents to the Commission. Records also must remain accessible to the Commission even after an entity is no longer in business or has ended its registration with the Commission. Rule 1002(b)(5) also prescribes a recordkeeping requirement for no or *de minimis* SCI events.

State model rule. Additionally, the North American Securities Administrators Association adopted a model rule and guidance in April 2015 regarding investment advisers' business continuity and succession planning. The model rule requires an investment adviser to establish written procedures for a business continuity and succession plan based on the adviser's business model, size, services provided, and number of locations. An adviser's plan must provide for: (i) protection of books and records; (ii) alternative modes of communication with customers, regulators, employees, and vendors; (iii) alternative office space; (iv) assignment of duties to qualified responsible persons if key persons are unavailable; and (v) the minimization of service disruptions and client harm from a business interruption. Colorado, Illinois, Iowa, Nebraska, Vermont and Wyoming (effective on an emergency basis from June 30, 2017 to October 28, 2017) have adopted versions of NASAA's model rule, while the model rule has been proposed by Michigan and Pennsylvania.

SEC disclosure issues. The SEC issued CF Disclosure Guidance: Topic No. 2 in 2011 to address the emerging disclosure issues surrounding cybersecurity. The guidance, which has not been updated since, acknowledges the fine line between revealing company vulnerabilities and keeping investors informed of company developments. As a result, a company must disclose enough information to meet SEC requirements and investors' needs, but does not have to give would-be hackers a roadmap to the company's technological weak spots.

As a result, companies may need to consider various aspects of their periodic and annual reports or other SEC filings with respect to cybersecurity. For example, a company may wish to update its risk factors section to include cybersecurity risks, although under Item 503(c) of Regulation S-K, this section must be specific to the company and should not include general risks applicable to any issuer or offering. A company also may need to decide whether to disclose material pending legal proceedings related to data breaches, such as direct or derivative law suits; Item 103 of Regulation S-K suggests some parameters for making litigation-related disclosures.

Moreover, Congress has thus far not enacted cybersecurity laws that would directly affect public company disclosures. But in the 114th Congress, former Rep. Jim McDermott (D-Wash) introduced the Cybersecurity Systems and Risks Reporting Act (H.R. 5069), which would have invoked the Sarbanes-Oxley Act's executive certification and internal controls provisions. Senators Jack Reed (D-RI) and Susan Collins (R-Maine) also introduced the Cybersecurity Disclosure Act of 2015 (S. 2410), which would have required companies to disclose if their boards have cybersecurity expertise. Senator Reed has re-introduced his bill in the 115th Congress (S. 536).

SEC enforcement. The SEC's Office of Compliance Inspections and Examinations continued its recent trend of listing the examination of SCI entities and cybersecurity among its market-wide examination priorities. OCIE also has flexibility overall to determine its examination needs based on its assessment of risks in the marketplace and at entities. OCIE previously conducted a cyber sweep of broker-dealers and investment advisers and published the results in a series of Risk Alerts (August 2017; September 2015; February 2015; April 2014).

OCIE recently issued a new risk alert following the discovery of a wide-spread ransomware attack. The risk alert summarized OCIE's latest examination sweep of 75 firms. According to OCIE, many broker-dealers, investment advisers, and investment companies still lack sufficient cybersecurity preparedness regarding periodic risk assessments of critical systems, penetration testing, and high-security patches. OCIE reminded firms that both the SEC and the Financial Industry Regulatory Authority have posted guidance on their websites. OCIE also recommended that firms review additional guidance issued by the Department of Homeland Security.

Resulting SEC enforcement matters are few in number, but two of them point out a common cybersecurity issue. In one settled administrative proceeding, the SEC alleged that registered investment adviser R.T. Jones Capital Equities Management, Inc. willfully violated the safeguards requirement of Rule 30(a) of Regulation S-P by failing to adopt written policies and procedures to deal with personally identifiable information of clients and others stored on an unencrypted third-party-hosted webserver. An unknown intruder gained access and copyrights to the data, but later investigations by multiple cyber consultants were unable to determine if the data was accessed or compromised. R.T. Jones was censured and agreed to pay a $75,000 civil money penalty after the Commission considered the firm's remedial steps and cooperation in the matter.

In another settled administrative proceeding, the SEC penalized Morgan Stanley Smith Barney LLC (MSSB), a registered broker-dealer and investment adviser, for similar violations of Regulation S-P regarding an employee who downloaded data on 730,000 customer accounts to a personal server that cyber forensics indicated was "likely hacked" by a third party. The employee obtained the data by leveraging a defect in MSSB's customer data analysis portal security that allowed him to generate reports on a wider set of customers than he was authorized to view. Some of the misappropriated data turned up for sale on multiple Internet sites. MSSB was censured and fined $1 million, but the Commission considered MSSB's cooperation and remedial efforts. The Commission likewise penalized the employee by imposing associational and penny stock bars; the employee also pleaded guilty to a federal criminal charge and was ordered to pay $600,000 in restitution and sentenced to three years' probation.

State securities regulation. New York has led the way in issuing rules for banks' cybersecurity, but Colorado also has adopted rules to bolster cybersecurity practices at broker-dealer and investment adviser firms. Colorado's Division of Securities held a public hearing on the proposed rules in early May. The rule could fuel a trend for more state regulation of cybersecurity that may grow beyond New York, Colorado and several states with related provisions.

The Colorado rules would require broker-dealers and investment advisers to establish written procedures that are reasonably designed to ensure cybersecurity. The commission could mull seven factors in determining compliance, including firm size, firm interconnectedness with third parties, and the firm's internal policies, training, and security efforts such as authentication practices. Broker-dealers and investment advisers would have to include cybersecurity in their risk assessments. Moreover, a firm's cybersecurity procedures must, to the extent reasonably possible, provide for: (i) annual cybersecurity risk assessments; (ii) email security, which includes encryption and digital signatures, (iii) authenticated employee access to electronic communications, databases, and other media; (iv) authentication of electronically communicated client instructions; and (v) disclosure to clients of the risks associated with the use of electronic communications.

New York has led the way in issuing rules for banks' cybersecurity, but Colorado also has adopted rules to bolster cybersecurity practices at broker-dealer and investment adviser firms.

A separate section of the Colorado rules defines key terms related to electronic offerings. "Security breach," for example, means unauthorized access to or disclosure of any data that compromises the security or confidentiality of confidential personal information maintained by the person or business. But the term applies only to systems used in connection with, or introduced into, securities offerings to enable the use of electronic offering documents or electronic signatures. "Offering documents" is broadly defined to include registration statements, prospectuses, and sales materials, while "sales materials" is limited to items to be used in connection with the solicitation of purchases of the securities approved as sales literature by the SEC, FINRA Inc., and state regulators.

Two other states addressed cybersecurity before Colorado issued its rules. Vermont's securities regulation has a provision that is strikingly similar to Colorado's new rule (Vt Code R ("Regulations of the Vermont Department of Financial Regulation") (Section 8-4). Vermont also defines "cybersecurity" (Id. (Section 1-2)) and lists the factors used to determine if a broker-dealer's supervisory procedures are reasonably designed to help detect and prevent violations and to achieve compliance with applicable rules, including a firm's use of Internet communications and its cybersecurity measures (Id. (Section 3-3)). Minnesota's Blue Sky law and securities regulation provide for the protection of purchaser information via the adoption of cybersecurity policies and the reporting of cybersecurity attacks or data breaches by issuers and portal operators subject to the state's revised MNVest registration exemption that works in tandem with the SEC's Securities Act Rule 147A, both of which became effective April 20, 2017 (Minn. Stat. §80A.461; Minn. R. 2876.3055).

Company boards, M&A, liability. Derivative suits against company boards over data breaches have struggled to take hold, but public company directors must remain focused on cyber-related disclosures, cyber insurance policies, and liability. One example is the dismissal with prejudice of a shareholder suit against Target Corporation after the company's special litigation committee issued its report on a data breach.

But that did not end the matter with respect to 47 state attorneys general, who recently reached a settlement with Target for $18.5 million. The settlement requires Target to assure that it will comply with various state laws, including consumer protection and personal information protection laws. The settlement also requires Target to implement an information security program for data it collects from customers. The information security program has some features in common with New York's banking cybersecurity regulation.

In an even more recent example, the U.S. District Court for the Northern District of Georgia dismissed a shareholder derivative suit against Home Depot, Inc. over a data breach accomplished by hackers using "BlackPOS" malware (the Target breach employed related malware) to gain access to point of sale payment card data systems. The Home Depot breach case has been closely watched despite the district court's earlier dismissal because of the ensuing appeal and the cybersecurity governance reforms contemplated by a proposed settlement.

According to the proposed settlement, the parties agreed to significant governance reforms regarding Home Depot's cybersecurity procedures, including a range of board and executive-level changes:

- Closer scrutiny of the company's chief information security officer.
- Oversight of the company's cybersecurity budget.
- Ensuring that the company is a member of at least one information sharing and analysis center or information sharing and analysis organization.
- Creating an executive-level committee on data security and privacy governance.
- Authorizing the board and audit committee to retain information technology and other experts.

Additional reforms required by the proposed settlement include table top exercises, monitoring for compromised systems, dark web monitoring, and maintaining an incident response team and incident response plan. The Eleventh Circuit stayed the appeal and remanded the case to the district court for the limited purpose of considering the proposed settlement. The district court has preliminarily approved the settlement and has scheduled a hearing on the settlement for October.

Cyber insurance and related commercial general liability and errors and omissions policies also raise many questions for company boards. In the Target example, the SEC staff had separately queried the company about its insurance coverage via the agency's filing review process.

The Home Depot breach case has been closely watched despite the district court's earlier dismissal because of the ensuing appeal and the cybersecurity governance reforms contemplated by a proposed settlement.

But mergers and acquisitions may become a new area of concern for boards. For example, Verizon Communications Inc. announced earlier this year that it will pay $350 million less to acquire Yahoo! Inc.'s operating business, a deal now valued at $4.48 billion, after disclosures about prior data breaches at Yahoo! The amended merger agreement assigns Yahoo! much of the potential liability for the breaches and provides that the breaches will not be a factor in determining if a "Business Material Adverse Effect" has occurred. The Yahoo! breach also is now the subject of a federal prosecution (additional DOJ statement) of a group of alleged perpetrators that includes two officers in the Russian Federal Security Service.

Blue Sky law: Regulation A+ and Rules 147/147A changes and additions

The SEC's Jumpstart Our Business Startups (JOBS) Act-inspired revamp of the seldom-used Regulation A, colloquially known as Regulation A+, created a tiered system for some types of smaller offerings. The SEC also has re-worked the rules for intrastate offerings by amending Securities Act Rule 147 and adding Rule 147A. Taken together, these regulatory changes have shaken up the Blue Sky community, especially as they relate to crowdfunding.

Regulation A+. The amendments to Regulation A arose from the 2012 JOBS Act, which Congress enacted to increase capital formation in the U.S. The SEC, following its JOBS Act mandate to facilitate capital formation and economic growth, adopted Regulation A+ on March 25, 2015 by incorporating the Regulation A amendments into Securities Act Rules 251 through 263. Rule 251 contains the most significant change—dividing Regulation A offerings into two tiers. Amended Regulation A became effective June 19, 2015.

Let's briefly explain how the two tiers impact the states. The SEC revised its Rule 256 "qualified purchaser" definition under Securities Act Section 18(b)(3) to be a person who is offered or sold securities in a Tier 2 offering. Because Section 18(b)(3) is a "covered" securities provision from the National Securities Markets Improvement Act of 1996 (NSMIA), which federally preempts state regulation, the new qualified purchaser definition, by applying to Regulation A Tier 2 offerings, preempts the states from requiring registration for those offerings. The states may, however, regulate Tier 1 offerings because they are excluded from the qualified purchaser definition.

Tier 1—A Tier 1 offering may not exceed $20 million, including not more than $6 million offered by the issuer's selling security holder affiliates. A Tier 1 offering comprises the aggregate offering price (i.e., the sum of all cash and other consideration received for the offered securities) plus the aggregate sales (i.e., the gross proceeds for all securities sold in accordance with other offering statements within the 12 months before the start of, and during, the current offering).

While most state securities commissioners have not yet changed their regulations to accommodate Tier 1, Vermont adopted a provision on July 1, 2016: an offer made under Tier 1 of Regulation A for which an issuer filed an offering statement on Form 1-A with the SEC must be registered with the Vermont Securities Commissioner by coordination, qualification and/or through a NASAA-administered Regulation A coordinated review process.

Another state, Delaware, amended its qualification registration rule on April 1, 2017 to declare that an issuer's filing a copy of an SEC-filed Form 1-A for a Regulation A, Tier 1 offering meets the qualification registration statement filing requirement.

> *While the states may not regulate securities offerings made under Tier 2, they may require an issuer to file a notice containing offering materials, a consent to service of process, and a fee.*

Tier 2—A Tier 2 offering may not exceed $50 million including not more than $15 million offered by the issuer's selling security holder affiliates. A Tier 2 offering comprises the same above-defined aggregate offering price and aggregate sales as for a Tier 1 offering.

While the states may not regulate securities offerings made under Tier 2, they may require an issuer to file a notice containing offering materials, a consent to service of process, and a fee. To date, the following 15 states have adopted provisions specifically requiring issuers to file a notice for a Regulation A Tier 2 offering: California, Colorado, Delaware, Idaho, Maine, Nebraska, New Hampshire, New Mexico, North Dakota, Oklahoma, Texas, Utah, Vermont, Washington and Wyoming. Iowa is proposing a Regulation A, Tier 2 notice filing. Michigan adopted a Regulation A exemption for issuers having SEC-filed federal Forms 1-A, and other states have "before Reg. A+ was ever adopted" filing requirements for Securities Act Section 18(b)(3) offerings.

State antifraud/enforcement provisions—Please note that both Tier 1 and Tier 2 offerings remain subject to state antifraud and enforcement provisions consistent with NSMIA's preemption framework.

Additional federal Rule 251 provisions—SEC Rule 251, after introducing the two tiers, then covers the following Regulation A topics:

- Additional limitation on secondary sales of Tier 1 and Tier 2 offerings in first year;
- Issuer eligibility, disqualification, and report filing requirement;
- Integration with other offerings;
- Offering conditions (offers and sales);
- Continuous or delayed offerings;
- Confidential treatment; and
- Electronic filing (which requires Regulation A documents to be federally submitted in electronic format through EDGAR).

A November 2016 published study prepared for Mark Flannery, then-Director and Chief Economist of the Division of Economic Risk Analysis, revealed that as of October 31, 2016, prospective issuers publicly filed offering circulars for 147 Regulation A + offerings on Form 1-A. The data showed that issuers are availing themselves of both Tier 1 and Tier 2, but Tier 2 offerings are more popular, accounting for 60 percent of the qualified offerings.

The most significant event to occur in the aftermath of Regulation A + adoption is the SEC's qualification and post-qualification amendment of Myomo, Inc., a medical robotics company, on June 9, 2017, making Myomo one of the first companies to complete a Regulation A + initial public offering listed on a national exchange, the NYSE MKT. Myomo raised approximately $8 million between the IPO and a private offering of investment units. The stock began trading with the symbol "MYO" on the NYSE MKT on June 12, 2017.

Additionally, one 2015-incorporated company classified as a New York-based sports and recreation membership club, 360 Sports Inc., became SEC-qualified in April 2016 and again in April 2017, to publicly sell shares in a Tier 1 offering.

Another issuer, HyGen Industries, Inc. is a California company organized to produce and distribute renewable hydrogen fuel in partnership with existing gas station owners. Beginning in 2017, HyGen will deploy the latest generation hydrogen production systems at partner locations throughout California. HyGen became SEC-qualified on March 22, 2017, to publicly sell shares in a Tier 2 offering.

SEC Rules 147 and 147A: Introduction. What led to the adoption of the Rule 147 amendments, along with new Rule 147A, was the SEC's need to ensure Rule 147's continuing utility. The Commission initially adopted Rule 147 in 1974 to provide a safe harbor for local businesses relying on the intrastate offering exemption under Securities Act Section 3(a)(11). For decades, Rule 147 successfully balanced local investor "capital formation financing" to local companies with investor protection. But modern business practices and communication technology have begun to erode the rule's continuing ability to strike this balance.

To fix the problem, the SEC first sought to simply amend Rule 147 but came to realize from the Commission's staff and industry experts that the best approach would involve supplementing the Rule 147 amendments with a brand new Rule—147A. Hence, following the close of the public comment period, the SEC adopted the existing rule amendments and the new rule on October 26, 2016. The Rule 147 amendments and new Rule 147A subsequently took effect on April 20, 2017.

Below is a chart comparing Rule 147 and Rule 147A on the various provisions which will be explained in detail:

	Requirements of Rule 147 (safe harbor under Section 3(a)(11))	Requirements of Rule 147A
The issuer is organized in-state.	✓	
The officers, partners, or managers of the issuer primarily direct, control and coordinate the issuer's activities ("principal place of business") in-state.	✓	✓
The issuer satisfies at least one of the "doing business" requirements described below.	✓	✓
Offers are limited to in-state residents or persons who the issuer reasonably believes are in-state residents.	✓	
Sales are limited to in-state residents or persons who the issuer reasonably believes are in-state residents.	✓	✓
The issuer obtains a written representation from each purchaser as to residency.	✓	✓

Source: Reproduced from *Intrastate Offering Exemptions: A Small Entity Compliance Guide for Issuers* (April 19, 2017) (prepared by SEC staff; internal footnotes omitted).

SEC Rule 147 (as amended) and Rule 147A: Distinguishing provisions—The most complex parts of the adoption are the two provisions which distinguish Rule 147 from Rule 147A, namely the issuer and investor residency provisions.

- ***Issuer residency***—Rule 147: To claim the Rule 147 safe harbor exemption, an issuer, if a corporation, must be a resident of the state or territory where: (1) it is incorporated or organized under state or territorial law; and (2) has its principal place of business. This requirement is historically in line with Section 3(a)(11), which declared upon enactment that an issuer, if a corporation, must be "incorporated by and doing business within such state or territory." And if a general partnership, limited liability company, or other business entity (not organized under state or territorial law), the issuer must similarly be a resident of the state or territory where its principal place of business is located.

  Rule 147A: The SEC, upon determining that the above in-state formation requirement under Rule 147 unduly burdened capital raising and economic growth, eliminated that requirement from Rule 147A so that corporate, general partnership, limited liability and other entity issuers need only be residents of the state or territory where their principal place of business is located.

  A "principal place of business" is the location from which the issuer's officers, partners or managers primarily direct, control and coordinate the issuer's activities. Note that if an issuer changes its principal place of business to another state after conducting an intrastate offering under either Rule 147 or Rule 147A, the issuer may not conduct another intrastate offering until the securities sold under the exemption in the prior state have come to rest in the other state.

- ***Investor residency—***Rule 147: Amended Rule 147, having retained the in-state residency requirement for issuers, also retains the in-state residency requirement for investors, namely that offers and sales be made exclusively to in-state residents.

  Rule 147A: As with the issuer residency requirement, Rule 147A also departs from amended Rule 147 on the investor residency requirement by allowing issuers to offer securities to out-of-state residents, provided the sales are limited to in-state residents. Because Rule 147A is not the historically restrictive Section 3(a)(11), Rule 147 safe harbor exemption, issuers relying on Rule 147A may make offers using general solicitation, general advertising, and other forms of mass media including unrestricted, publicly available Internet websites, so long as sales are made only to investors who reside in the state or territory where the issuer is a resident. This relaxation of the investor residency requirement helps fulfill the SEC's purpose for Rule 147A as a capital-raising exemption.

Viewing the issuer location and investor residency requirements together, the SEC's reason for mandating an issuer to be a resident of the same state where its purchasers reside (or where, as explained later, the issuer reasonably believes they reside), and has its principal place of business in the same state or territory where the offering takes place, is to ensure the local, intrastate character of Rule 147 and 147A offerings. Regarding purchasers, note that the principal place of business only applies to purchasers who are legal entities (as explained later).

SEC Rule 147 (as amended) and Rule 147A: Commonalities—The SEC, after adopting the two requirements that distinguish Rule 147 from 147A, set forth provisions applicable to both exemptions.

- "Doing business." The SEC relaxed certain "doing business" requirements for Rule 147 and 147A upon recognizing the increasingly interstate nature of small business activities that companies physically located in a single state or territory began to find difficult to comply with. Previously, Rule 147 required that for an issuer to be considered "doing business in state," the issuer:

  — Had to derive at least 80 percent of its consolidated gross revenues from the operation of a business, from real property located in-state, or from rendering of services in state;
  — Needed to have at least 80 percent of its consolidated assets in-state; and
  — Had to intend to use (or currently use) at least 80 percent of the offering's net

proceeds for the operation of a business or real property in-state, or for the purchase of real property located in-state, or for rendering services in-state.

The Commission adopted a relaxed "doing business" requirement for Rule 147 or 147A offerings by permitting an issuer to meet at least one of the above provisions rather than all three provisions, or alternatively satisfy the requirement by:

— Having a majority of its employees based in-state.

The SEC believes that the relaxed requirement will make it easier for issuers to conduct intrastate offerings while preserving the in-state nature of the issuers' business.

- "Reasonable belief" standard. The SEC adopted a reasonable belief standard for the investor residency requirement. For both amended Rule 147 and new Rule 147A offerings, the requirement is met if: (1) the securities purchaser is, in fact, a resident of the state or territory where the issuer is a resident; or (2) the issuer reasonably believes that the purchaser is a resident of that state or territory. The SEC proclaims that having a reasonable belief standard increases issuer use of Rule 147 and 147A by providing the issuers with some certainty about the exemptions' availability, while simultaneously blocking purchasers from buying out-of-state investments.
- Purchaser residency representation. For both amended Rule 147 and new Rule 147A, a purchaser's representation that he or she is a resident of the same state or territory as the issuer will not, by itself, support the issuer's reasonable belief of investor residency without supporting documentation proving investor residency, such as:
  - — Proof of a pre-existing relationship between the issuer and prospective purchaser; or
  - — Prospective purchaser's home address, recently dated utility bill, pay-stub, federal/state income tax return, driver's license, identification card; or
  - — Public or private database that the issuer has determined is reasonably reliable to prove investor residency, e.g., credit bureau databases, directory listings, or public records.
- Non-natural person residency. The Commission determined that for Rule 147 and 147A, the "residence of a non-natural person purchaser," i.e., a legal entity such as a corporation, partnership, trust or other business organization, is the location where, at the time of sale, the entity has its principal place of business. And as stated above, a purchaser's "principal place of business" is the location where the entity's officers, partners or managers primarily direct, control and coordinate the entity's activities. Regarding trusts, a trust that is not considered a separate legal entity by the law of the state or territory where it was created is a resident of each state or territory where its trustee(s) is/are resident.
- Resale limit. A resale limitation, applied to both amended Rule 147 and new Rule 147A, mandates that a resale occurring during the first six months starting with the date the issuer initially sold the security to a purchaser may be made only to persons resident of the state or territory where the issuer was resident at the time of making the original sale to the purchaser. Furthermore, if an issuer changes its state or territory during this six-month period, all resales will remain limited to the state or territory where the issuer resided at the time of the original sale.
- Disclosures and legends. Issuers must prominently disclose the following items to offerees and purchasers. But while amended Rule 147 and new Rule 147A contain legend requirements, the disclosures do not always have to be in writing:
  - — "Sales only to in-state residents." Amended Rule 147 and new Rule 147A both require issuers to prominently disclose on all offering materials that sales can be made only to investor-residents of the same state or territory as the issuer. The SEC believes these disclosures will best alert potential investors that only those investors who are residents of the same state where the issuer is a resident can participate in the offering.
  - — Resale limits. Issuers must prominently disclose the above-mentioned resale limitations to offerees and purchasers in Rule 147 and 147A offerings.
  - — Integration. Offers and sales conducted in accordance with Rule 147 or Rule 147A will not be integrated with:

— Prior offers or sales of securities; or
— Subsequent offers or sales of securities that are: (i) registered under the Securities Act, except as provided in Rule 147(h) or Rule 147A(h); (ii) exempt from registration under Regulation A; (iii) exempt from registration under Rule 701; (iv) made pursuant to an employee benefit plan; (v) exempt from registration under Regulation S; (vi) exempt from registration under federal Regulation Crowdfunding [Securities Act Section 4(a)(6) and 18(b)(4)(C)]; or (vii) made more than six months after completing a Rule 147 or Rule 147A offering.

Rule 147 and 147A offerings: State securities impact—The SEC decided not to adopt federal proposals that would have limited Rule 147 and 147A to either: (1) offerings registered in the state where all purchasers reside; or (2) offerings exempt from registration in a state where the amount of securities an issuer may sell is limited to $5 million in a 12-month period. The Commission determined that resident investor protections in intrastate offerings should flow primarily from state rather than federal securities law requirements.

Regarding filings, the SEC determined that issuers conducting Rule 147 or 147A offerings do not have to file any information with, or pay any fee to, the Commission. Issuers must, however, comply with the securities laws and regulations of the state where the securities will be offered or sold.

Regarding integration, while Rule 147A(g)(1) provides that offers and sales will not be integrated with prior offers and sales of securities (see above under "Integration" provision), issuers must comply with all applicable state securities law requirements.

Lastly, the states have begun amending the following requirement "an issuer's crowdfunding offering must comply with SEC Rule 147" to read "an issuer's crowdfunding offering must comply with either SEC Rule 147 or Rule 147A." Colorado has taken the lead here.

Conclusion

The window for congressional disapproval of SEC rules under the CRA will eventually close and the inquiry will instead shift to whether lawmakers can pass a major Dodd-Frank Act corrections bill and whether it will repeal or modify large swaths of the Dodd-Frank Act's securities provisions, including the SEC's statutory authority to adopt rules for resource extraction issuers and for conflict minerals. The House GOP-led Financial CHOICE Act of 2017 (H.R. 10) would repeal these provisions, but that bill faces strong opposition from Senate Democrats.

Fintech and cybersecurity appear destined to become omnipresent issues. The federal government generally continues to refine its approach to cybersecurity, and the SEC could someday update its 2011 disclosure guidance. Meanwhile, cybersecurity will remain a significant issue for company boards on many fronts, including mergers and acquisitions. Fintech is still an emerging issue for federal and state regulators, but developments at the SEC regarding the listing and trading of shares in virtual currency trusts will evolve in parallel to innovations at other financial regulators, including the Office of the Comptroller, which has conceived of a fintech bank charter.

Meanwhile, the choice of Jay Clayton to lead the SEC could result in renewed efforts by the agency to stimulate IPOs and capital formation. Clayton previously was a partner at Sullivan & Cromwell LLP where he focused on securities offerings and transactions. Less than a week after being sworn in as Chairman, Clayton told the SEC Advisory Committee on Small and Emerging Companies that "[f]acilitating capital formation is one of the central tenets of the SEC's mission and it is a focus that this committee and I share."

Since then, Clayton gave a speech in which he posited eight principles for securities regulation, while also hinting at the potential relief that was to be announced regarding use of requests under Rule 3-13 of Regulation S-X for issuers eligible to submit confidential draft registrations via an expanded program that initially included only EGCs." Congress continues to mull further refinements to the JOBS Act that could spur renewed interest in rules for crowdfunding and other modes of capital formation.