Securities Regulation Daily Wrap Up, TOP STORY—IPOs, ICOs, and capital formation: Corp Fin chief testifies on Capitol Hill, (Apr. 27, 2018)

Securities Regulation Daily Wrap Up

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The director of the SEC's Division of Corporation Finance testified before the Capital Markets, Securities, and Investment Subcommittee. Director William Hinman's testimony covered a wide range of issues, including recent Division initiatives, with a particular focus on capital formation and issues surrounding cybersecurity disclosures and the regulation of virtual currencies.

The decline of IPOs. In his opening remarks, Subcommittee Chairman Bill Huizenga (R-Mich) expressed his concern about the declining number of public companies in the United States. This sentiment was echoed by a number of his fellow committee members, including Rep. Thomas MacArthur (R-NJ), who took a swipe at "overzealous" state attorneys general. MacArthur speculated that the decrease in the number of IPOs in recent years could be attributed to public companies being the targets of litigation for civil fraud where a state attorney general lacks evidence to prosecute a company for criminal fraud.

Hinman acknowledged that regulations at both the state and federal level might be contributing to the decline in IPOs. He also noted that there is more money available in the private sector right now, so the need to seek public funding is lower than it was in the past. Regarding the issue of litigation raised by MacArthur, Hinman said it would be a matter of federal statute and federal preemption.

ICOs. Several members of the subcommittee quizzed Hinman about initial coin offerings (ICOs). Huizenga inquired if there is a scenario where an ICO might not be regulated as a security. Hinman noted that SEC Chairman Jay Clayton has remarked that, for the most part, ICOs resemble investment contracts under the *Howey* test, and as such are securities and should be regulated as such. However, he said that, in theory, there may be a time when a coin may achieve a decentralized utility in the marketplace, so there would not be an issuer to regulate and to require disclosure as a securities offering.

Representative Brad Sherman (D-Calif) was less than enthusiastic about the rise of ICOs. According to Sherman, the reason for the securities markets is to provide jobs in the real economy, which an IPO does, but an ICO does not. With ICOs, "it takes people willing to invest and risk [who] don't use those risks to create a job for a person who needs one, let alone build a factory for thousands" and who "sit there and trade back and forth in the ICO," he said. Under a balanced approach, the balance in the "real economy" is wanting people to invest in new companies while still protecting investors, Sherman said. But with ICOs, there is no factory or jobs, so the balance regarding ICOs favor investors over tokens that "facilitate drugs and tax evasion." Sherman said that this balance actually tilts in favor of banning ICOs completely.

Hinman replied that ICOs allow for a different type of enterprise, one that is more decentralized. "Charlatans and scammers have always favored decentralized new enterprises," Sherman retorted. Representative Tom Emmer (R-Minn) did not share his colleague's skepticism about ICOs. "There's a lot of ignorance about how special this area is," he said. He asked about when a token sale might not be a securities offering, pointing in particular to "utility tokens," because those are not used for capital formation. Hinman replied that it is possible that there are tokens that would not have the hallmarks of a security, such as where the holder is buying it for its utility, and not as an investment.

Cybersecurity. Hinman also responded to member questions about the SEC's focus on cybersecurity. Representative Anne Wagner (R-Mo) inquired about the SEC's recent guidance on cybersecurity disclosure and how companies should treat a cybersecurity breach. Hinman said that if a company identifies cybersecurity as a

material risk, the SEC will expect to see disclosures about how the board of directors conducted oversight of that risk.

Representative Stephen F. Lynch (D-Mass) was less than enthused about company disclosure of cyberattacks, noting that last year, of the companies that had major cyber breaches, only 3 percent filed Forms 8-K to inform their shareholders that their systems had been hacked. Lynch said that companies, who are victims of a cyberattack, shouldn't be punished as victims, but they should still be encouraged to disclose these breaches.

Hinman acknowledged that the question of materiality regarding cyber breaches can be a difficult one. He said that when the staff sees news reports that a hack has occurred, they call the company to talk to the company's counsel and ask to be walked through the analysis of why a particular breach was not material. Responding to a similar question from Rep. Bruce Poliquin (R-Maine), Hinman said that the Commission's cybersecurity disclosure guidance does not require bright line disclosures because those tend to be either under-inclusive or over-inclusive. Instead, the Commission uses a principles-based guidance, Hinman advised.

Corp Fin agenda. Representative Keith Ellison (D-Minn) noted that eight years after the Dodd-Frank Act was passed, key rulemaking initiatives involving executive compensation, including pay ratio disclosure, incentive-based compensation guidelines, and clawback rules, have not been finalized by the SEC. Ellison pressed Hinman on a timeline for Commission action on these rules, which Hinman could not provide, although he explained that due to the Commission's busy agenda, action on executive compensation rules would not happen in this fiscal year.

Some subcommittee members asked Hinman about proxy advisory firms and whether the SEC is considering expanding its oversight of the two main proxy advisory firms. Hinman replied that Chairman Clayton has indicated his interest in the issue and told the members that the staff is currently gathering information about proxy advisory firms, but in the meantime directed their attention to the Commission's 2014 Staff Legal Bulletin on proxy voting.

Ranking Member Carolyn Maloney (D-NY) sought assurances from Hinman that the Division would not change the SEC's decades-long stance that companies preparing an IPO cannot insert forced arbitration clauses in their offering documents. She noted that she and several other members of the House Financial Services Committee had written a letter to Clayton expressing opposition to such provisions, which have recently been a topic of conversation following an article published in *Bloomberg* indicating that SEC staff was "laying the groundwork" to allow these clauses.

Hinman noted that Clayton has stated that allowing mandatory arbitration in IPO documents is not on the Commission's agenda. He also advised that the issue involves not only the federal securities laws, but also arbitration laws and state laws. Citing Clayton's recent response to Maloney's letter, if a registration containing a forced arbitration provision is filed with the SEC, it would not be reviewed at a Division level, but would be deferred to the entire Commission, Hinman said.

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