October 17, 2022

Q3 2022 U.S. Legal & Regulatory Developments

The following is our summary of significant U.S. legal and regulatory developments during the third quarter of 2022 of interest to Canadian companies and their advisors.

1. SEC Finalizes Pay-for-Performance Rules

The United States Securities and Exchange Commission (the "SEC") has finalized its pay-for-performance disclosure rules, largely as proposed. These rules implement Section 14(i) of the Securities Exchange Act of 1934 (the "Exchange Act"), as added by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 14(i) directs the SEC to adopt rules requiring reporting companies to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the company.

These new pay-for-performance rules require reporting companies to disclose in their proxy and information statements a new standardized figure for compensation "actually paid" (that is, total compensation otherwise reported in the proxy with the adjustments to pension and equity award methodologies) to the principal executive officer and to the remaining named executive officers; tabular disclosure of certain performance measures, including absolute and relative total shareholder return and net income; and a description of the relationship between the performance measures and compensation. Disclosure is required for the last five fiscal years, subject to a transition period.

These requirements apply to all reporting companies, except foreign private issuers, registered investment companies and emerging growth companies. Smaller reporting companies are subject to scaled reporting requirements.

The rules became effective on October 11, 2022, and the new disclosure is now required in proxy and information statements disclosing compensation for fiscal years ending on or after December 16, 2022. For companies with calendar year fiscal years, this means that they will need to promptly start collecting the information to prepare this disclosure, which for many companies will be part of filings in the next four to six months, which gives a short lead-time for compliance.

For the full text of our memorandum, please see:

- https://www.paulweiss.com/media/3982230/sec_finalizes_pay_for_performance_rules.pdf

For the SEC final rules, please see:

- https://www.sec.gov/rules/final/2022/34-95607.pdf

2. SEC Rescinds Selected Proxy Voting Advice Rules and Guidance

On July 13, 2022, the SEC adopted amendments to rescind parts of its 2020 rulemaking and guidance on proxy voting advice. These amendments address the concerns of proxy advisory firms and investors regarding the adverse cost, independence, timeliness and liability impacts of certain of the 2020 proxy voting advice rules. These amendments became effective on September 19, 2022. Despite these actions, Institutional Shareholder Services' litigation related to these rules appears to be proceeding as the proxy advisor's view is that the rules should be rescinded in their entirety.

The amendments:

- Eliminate the Rule 14a-2(b)(9)(ii) conditions to the exemption from the proxy solicitation information and filing requirements for proxy voting advice, which had required that (i) companies that are the subject of proxy voting advice have such advice made available to them at or prior to the time such advice is disseminated to the proxy advisory firm's clients; and (ii) the proxy advisory firm provides its clients with a mechanism by which they can reasonably be expected to become aware of any written statements regarding its proxy voting advice by companies that are the subject of such advice, in a timely manner prior to the security holder meeting.

  The elimination of these conditions means that while companies have access to data verification processes established by the key proxy advisory firms, they do not otherwise have access to proxy advisory firm voting recommendations other than on a post-issuance or paid basis, depending on the particular firm. Subsections (iii), (iv), (v) and (vi) of Rule 14a-2(b)(9), which addressed the conditions and exemption therefrom, have also been deleted.

- Rescind the SEC's 2020 Supplemental Proxy Voting Guidance, which was issued, in part, to accompany the adoption of Rule 14a-2(b)(9)(ii), to assist investment advisers in assessing how to consider company responses to proxy voting advice.

- Amend Rule 14a-9 to remove Note (e), which identifies as examples of material misstatements or omissions "failure to disclose material information regarding proxy voting advice covered by Rule 14a-1(l)(1)(iii)(A), such as the proxy voting advice business's methodology, sources of information, or conflicts of interest."

  The SEC clarified that the deletion of Note (e) does not affect a proxy advisory firm's liability under Rule 14a-9 for materially misleading statements or omissions, including those relating to its methodology, sources of information or conflicts of interest.

These amendments do not affect other aspects of the 2020 proxy voting advice rules, which remain in place and effective as to proxy advisory firms and their advice. Notably:

- proxy voting advice remains a solicitation subject to the proxy rules;

- to rely on the exemptions from the proxy rules' information and filing requirements, proxy advisory firms continue to be subject to the conflicts of interest disclosure requirements; and

- material misstatements or omissions of fact in proxy voting advice remain subject to liability under Rule 14a-9 (as noted above).

The amendments do not affect the SEC's 2019 interpretive guidance regarding the treatment of proxy voting advice as a solicitation.

For the full text of our memorandum, please see:

- https://www.paulweiss.com/media/3982122/sec_rescinds_selected_proxy_voting_advice_rules_and_guidance.pdf

For the SEC final rules, please see:

- https://www.sec.gov/rules/final/2022/34-95266.pdf

3. Second Circuit Affirms That Misrepresentations and Omissions Cannot Be the Sole Basis for Liability under Rule 10b-5(a) and (c)

On July 15, 2022, the Second Circuit held in SEC v. Rio Tinto plc ("Rio Tinto") that the Supreme Court's ruling in Lorenzo v. SEC ("Lorenzo") did not abrogate the rule in the Second Circuit that alleged misrepresentations and omissions cannot be the "sole basis" for liability under Rule 10b-5(a) and (c).

In Lorenzo, the Supreme Court held that a person who disseminates materially misleading statements with the intent to defraud investors can be held primarily liable under Section 17(a)(1) of the Securities Act of 1933, Section 10(b) of the Exchange Act, and SEC Rule 10b-5(a) and (c), even if that person does not "make" any statement to investors. The Supreme Court based its decision on the text of the rule and overlap of the rule's provisions. The Supreme Court also noted the limits of its decision, emphasizing that its holding does not render its decision involving separate requirements for "maker" liability under Rule 10b-5(b) a "dead letter," nor does it "create[] a serious anomaly or otherwise weaken[] the distinction between primary and secondary liability."

After the Supreme Court's decision, the lower courts have been grappling with the impact of Lorenzo on securities laws. The Second Circuit's decision in this case clarifies that Lorenzo does not mean that the separate provisions of Rule 10b-5 are fully overlapping.

Factual and Procedural Background

In a complaint filed in the Southern District of New York in 2017, the SEC alleged that defendants Rio Tinto plc and Rio Tinto Ltd., and their former CEO, Tom Albanese, and CFO, Guy Elliott, made a series of alleged misstatements and omissions in connection with the value of an undeveloped, exploratory mining asset in Mozambique that they acquired in 2011 for $3.7 billion. The defendants moved to dismiss all the claims.

In 2019, Judge Analisa Torres dismissed the vast majority of the claims in the action, including all of the scheme liability claims brought under Rule 10b-5(a) and (c), as well as under Section 17(a)(1) and (a)(3). With respect to the Rule 10b-5(a) and (c) claim, Judge Torres held that "the SEC must allege 'the performance of an inherently deceptive act that is distinct from an alleged misstatement.'" Judge Torres also noted, however, that the pending Supreme Court decision in Lorenzo "may clarify" the standard for Rule 10b-5(a) and (c) claims.

After the decision on the motion to dismiss, the Supreme Court issued its decision in Lorenzo. The SEC ultimately filed a motion for reconsideration, which was denied. In denying the motion for reconsideration, Judge Torres explained that the only actions identified by the SEC were "misstatements or omissions," and Lorenzo only held that those who "disseminate" false or misleading statements can be liable, "not that misstatements alone are sufficient to trigger scheme liability."

Following the denial of reconsideration, the SEC requested interlocutory review, and the review was granted.

Second Circuit Opinion

In Lentell v. Merrill Lynch & Co. ("Lentell")—a decision pre-dating Lorenzo—the Second Circuit held that "misstatements and omissions cannot form the 'sole basis' for liability under the scheme subsections." Rio Tinto thus presented the question whether Lorenzo abrogated Lentell. The Second Circuit held that Lentell "remains vital" post-Lorenzo.

The Second Circuit explained that adopting the SEC's expansive view of Lorenzo would eliminate the distinctions between Rule 10b-5(a) and (c) on the one hand and Rule 10b-5(b) on the other, and would "undermine two key features of Rule 10b-5(b)."

First, it would undermine the Supreme Court's ruling in Janus Capital Group, Inc. v. First Derivative Traders ("Janus") that the "maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it," and those that do not "make" a statement, cannot be liable under Rule 10b-5(b). Since the decision in Lorenzo "emphasized the continued vitality of Janus," the Second Circuit reasoned that Lentell is necessary to give continuing effect to Janus.

Second, the SEC's view would undermine the rule that "misstatements and omissions claims brought by private plaintiffs under Rule 10b-5(b) are subject to the heightened pleading standard of the Private Securities Litigation Reform Act." The Second Circuit's decision to affirm Lentell prevents "private litigants [from] repackag[ing] their misstatement claims as scheme liability claims."

Finally, the Second Circuit resisted "overreading Lorenzo" because it could "muddle primary and secondary liability" by allowing liability for participating in the preparation of alleged misstatements. Only the SEC is allowed to bring claims alleging aiding and abetting liability, and the Supreme Court in Lorenzo disclaimed any attempt to weaken the distinction between primary and secondary liability.

The Second Circuit's decision ultimately reconciles Lentell and Lorenzo. Lentell instructs litigants "that misstatements and omissions alone are not enough for scheme liability," and Lorenzo provides an example of conduct, dissemination of false or misleading statements, that is "something extra that makes a violation a scheme."

Implications

Rio Tinto is the Second Circuit's first decision since Lorenzo to address the scope of scheme liability under the federal securities laws. Under Rio Tinto, it is clear that pre-Lorenzo cases like Lentell remain good law, and a plaintiff cannot plead securities fraud under (a) or (c) of Rule 10b-5 absent allegations that the particular defendant(s) engaged in deceptive conduct beyond knowingly making a false or misleading statement. Rio Tinto thus reaffirms an important limitation on the ability of the SEC and private plaintiffs to pursue scheme liability claims. While the decision is only binding in the Second Circuit, we expect that the case will be cited in other jurisdictions as persuasive authority given that the Second Circuit is the "'Mother Court' of securities law." We anticipate seeing further development of the law in this area as courts apply Rio Tinto in the coming years.

For the full text of our memorandum, please see:

- https://www.paulweiss.com/media/3982129/second_circuit_affirms_that_misrepresentations_and_omissions_cannot_be_the_sole_basis_for_liability_under_rule_10b_5a_and_c.pdf

For the Second Circuit's opinion in *SEC v. Rio Tinto plc*, please see:

- https://law.justia.com/cases/federal/appellate-courts/ca2/21-2042/21-2042-2022-07-15.html

4. SEC Proposes to Narrow Exclusions under Rule 14a-8

On July 13, 2022, the SEC proposed amendments to Rule 14a-8, which would narrow the circumstances under which companies may exclude shareholder proposals on the grounds that they are "substantially implemented," "substantially duplicate" another proposal or are a resubmission that did not meet specified approval rates in prior years. These grounds for exclusion represent a significant proportion of Rule 14a-8 no-action requests, and many shareholder proposals that would have been excludable under current practice would no longer be under the proposed amendments. This proposal is the most recent move by the SEC to limit exclusion of shareholder proposals, following Staff Legal Bulletin 14L and other policy changes. If adopted, the practical implication is that more shareholder proposals will be included in proxy materials, and companies will have to appeal directly to shareholders regarding their suitability either in the company statement of opposition or via engagement.

Substantially Implemented: Under Rule 14a-8(i)(10), a company may exclude a proposal that has been "substantially implemented." The amendments would provide that a company has substantially implemented a proposal only if the company has already "implemented the essential elements of the proposal." This would involve a factual analysis to identify the essential elements of the proposal and whether they have been addressed. All essential elements would need to be implemented in order to exclude the proposal. The SEC identified examples highlighting the strict focus on the implementation of the "essential element" requirement, which reflect changes to the Staff's historical practice:

- A proxy access proposal requesting to allow an unlimited number of shareholders who collectively own 3% of the company's outstanding common stock for three years to nominate up to 25% of the company's directors would not be excludable where the company already has a proxy access provision that allows a group of up to 20 shareholders meeting those ownership thresholds to nominate up to 20% of the board because the essential element of the proposal is that the group be an unlimited number of shareholders;

- A proposal requesting a report from the company's board of directors, where management already delivers such a report, would not be excludable if the proposal emphasizes reporting from the board and thus an essential element is the involvement of the board (rather than management).

The SEC noted, however, that the more objectives, elements or features a proposal identifies, the more likely that the Staff would view each of them as less essential.

Substantially Duplicates: Under Rule 14a-8(i)(11), a company may exclude a proposal that "substantially duplicates" another proposal that has been submitted for the same meeting. The amendments would provide that a proposal "substantially duplicates" another proposal if it "addresses the same subject matter and seeks the same objective by the same means as" the other proposal. These proposed changes would also require an analysis of the objectives and means of the proposals and where they differ (even though addressing the same subject matter), would not permit exclusion of subsequent proposals.

Resubmission: Under Rule 14a-8(i)(12), a company may exclude a proposal that addresses "substantially the same subject matter" as a previous proposal that failed to meet required voting thresholds. The amendments would incorporate the "substantially duplicates" standard in Rule 14a-8(i)(11) above. As a result, proposals would only be excludable under Rule 14a-8(i)(12) if they address the same subject matter and seek the same objective by the same means as a prior proposal.

For the full text of our memorandum, please see:

- https://www.paulweiss.com/media/3982121/sec_proposes_to_narrow_exclusions_under_rule_14a_8.pdf

For the SEC final rules, please see:

- https://www.sec.gov/rules/final/2022/34-95266.pdf

5. Second Circuit Rules That Retaliatory Intent Is an Element of a Sarbanes-Oxley Whistleblower Claim

On August 5, 2022, the Second Circuit held that individuals claiming they were terminated in retaliation for protected whistleblower activities under Sarbanes-Oxley must prove that their employer acted with retaliatory intent. Murray v. UBS Securities LLC, No. 20-4202 (2d Cir.). The decision raises the bar for plaintiffs to plead and prove a claim under Sarbanes-Oxley's anti-retaliation provision, 18 U.S.C. § 1514A, and may reduce the cost to settle such claims. The decision also creates a split with the Fifth and Ninth Circuits, which previously held that retaliatory intent is not an element of a section 1514A claim, and raises the prospect that the issue will be considered by the Supreme Court.

Background

In 2014, Trevor Murray filed a complaint against his former employer, UBS, alleging that he was terminated in violation of section 1514A. Murray had worked as a strategist in UBS's commercial mortgage-backed securities business, where he researched and drafted reports for distribution to UBS's current and potential client base. Murray alleged and testified at trial that, even though SEC regulations required him to certify that his reports were produced independently and reflected his own views, he was pressured by leaders of the trading desk to skew his research and publish reports to support their business strategies. Murray reported this conduct to his supervisor in December 2011 and January 2012, and was terminated in February 2012. Murray alleged that his termination was retaliation for whistleblowing; UBS argued that it terminated Murray due to a shift in business strategy.

After the close of evidence at trial, the district court instructed the jury that to succeed on his section 1514A claim, the plaintiff must prove, among other things, that his "protected activity was a contributing factor in the termination of his employment." The court went on to explain, however, that the plaintiff was "not required to prove that his protected activity was the primary motivating factor in his termination, or that UBS's articulated reasons for his termination . . . was a pretext, in order to satisfy this element." UBS objected that the court failed to instruct the jury that proof of retaliatory intent is an element of a section 1514A claim, but the court overruled the objection.

The jury found UBS liable and returned an advisory damages verdict recommending that Murray receive $903,300 in back pay and non-economic damages, which the district court adopted. The district court also awarded Murray more than $1.7 million in attorneys' fees. UBS appealed.

The Second Circuit Opinion

A three-judge panel of the Second Circuit unanimously held that the district court erred by failing to instruct the jury that retaliatory intent is an element of a section 1514A claim, vacated the $2.67 million award, and ordered a new trial.

The court explained that the plain statutory language indicates that retaliatory intent is an element of a section 1514A claim. Section 1514A states that no covered employer "may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee . . . because of" whistleblowing. The court focused on the meaning of "discriminate" and "because of," and explained that the statute prohibits actions based on conscious disfavor ("discrimination") motivated by ("because of") the employee's whistleblowing. The court also relied on its previous interpretation of the nearly identical antiretaliation provision of the Federal Railroad Safety Act ("FRSA"), which the Second Circuit held in 2018 requires "some evidence of retaliatory intent." Thus, the court concluded that, to succeed on a section 1514A claim, whistleblowing employees must prove by a preponderance of the evidence that the employer took adverse employment action against them with retaliatory intent.

The Second Circuit acknowledged that its decision was inconsistent with decisions from the Fifth and Ninth Circuits, which held that retaliatory intent is not an element of a section 1514A claim. The court stated that the other appellate courts "overlooked the plain meaning of the [statutory] text," and noted that different appellate courts—the Seventh and Eighth Circuits—had interpreted the same language in the FRSA as requiring retaliatory intent.

Implications

The Second Circuit's decision makes it more difficult for plaintiffs (within the circuit) to succeed on anti-retaliation claims under the Sarbanes-Oxley whistleblower statute. It is no longer sufficient for plaintiffs to show that their protected activity was a "contributing factor" to their termination—they now must also produce evidence of the employer's intent to retaliate. This could significantly reduce the number of Sarbanes-Oxley whistleblower actions that survive motions for judgment as a matter of law, or that result in a plaintiff's verdict after trial. The increased burden on whistleblowing plaintiffs may also reduce the cost to settle anti-retaliation claims.

The decision also creates a circuit split on the issue of whether retaliatory intent is an element of a section 1514A claim. It remains to be seen whether other circuit courts will adopt the Second Circuit's reasoning and require proof of retaliatory intent in such cases, and whether the Supreme Court will weigh in on this issue to resolve the split.

For the full text of our memorandum, please see:

- https://www.paulweiss.com/media/3982208/second_circuit_rules_that_retaliatory_intent_is_an_element_of_a_sarbanes-oxley_whistleblower_claim.pdf

For the Second Circuit's opinion in *Murray v. UBS Securities LLC*, please see:

- https://law.justia.com/cases/federal/appellate-courts/ca2/20-4202/20-4202-2022-08-05.html

6. SEC Proposes Heightened Private Fund Reporting on Form PF

On August 10, 2022, the SEC and Commodity Futures Trading Commission ("CFTC") proposed joint amendments to Form PF ("Proposed Amendments") that are designed, according to the proposing release, to enhance the Financial Stability Oversight Council's ability to assess systemic risk and bolster the SEC's regulatory oversight of private fund advisers, as well as to provide greater insight into private funds' operations and strategies, assist in identifying trends, improve data quality and comparability and reduce reporting errors. If adopted, the Proposed Amendments would:

- substantially increase, in scope and granularity, reporting by "large hedge fund advisers" on "qualifying hedge funds" (generally, those with a net asset value of at least $500 million);
- remove aggregate reporting for large hedge fund advisers;
- amend reporting on basic information about advisers and the "private funds" they advise;
- expand reporting concerning "hedge funds"; and
- amend reporting on "master-feeder arrangements," "parallel fund structures" and funds of funds.

The Proposed Amendments are the second set of amendments to Form PF that have been proposed in 2022. In January, the SEC proposed amendments ("January Proposal") that would amend sections 3 and 4 of Form PF (which, respectively, address "liquidity funds" and "private equity funds" advised by "large private fund advisers"), as well as add new sections 5 and 6 (which, respectively, would address large hedge fund advisers and all advisers to private equity funds). The January Proposal was issued only by the SEC, not the CFTC, and those amendments have not become final. By contrast, with respect to sections 1 and 2, Form PF is a joint form of the SEC and CFTC, and therefore the Proposed Amendments were issued jointly by the agencies with respect to dual registrants (i.e., private fund investment advisers registered with the SEC and commodity pool operators registered with the CFTC).

Significant pushback from the private funds industry is anticipated, both with respect to the substance of the additional reporting requirements and the increased compliance costs associated with such granular reporting on Form PF. While many private fund advisers have adopted language in their expense allocation provisions that permits Form PF-related costs to be allocated to their private fund clients, there is a question as to whether the SEC's recently proposed series of sweeping new rules prohibiting certain activities relating to private funds ("February Proposal"), if adopted as proposed, would permit such expense allocations going forward.

For the full text of our memorandum, please see:

- https://www.paulweiss.com/media/3982214/sec_proposes_heightened_private_fund_reporting_on_form_pf.pdf

For the Proposed Amendments, please see:

- https://www.sec.gov/rules/proposed/2022/ia-6083.pdf

For the January Proposal, please see:

- https://www.sec.gov/rules/proposed/2022/ia-5950.pdf

For the February Proposal, please see:

- https://www.sec.gov/rules/proposed/2022/ia-5955.pdf

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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