

## 6 SEC Regulatory Prospects To Watch In 2019

By Tom Zanki

*Law360 (January 1, 2019, 12:03 PM EST)* -- From controversial rules intended to impose a higher standard of conduct on broker-dealers to potential changes to the quarterly reporting system for public companies, the U.S. Securities and Exchange Commission

plans to tackle wide-ranging issues in 2019 that could have a lasting impact on long-term investors, a key focus of chairman Jay Clayton's leadership.

Clayton has made protecting retail investors and expanding their investment choices top priorities since taking the helm in 2017. Under his watch, the SEC has introduced a sweeping proposal to clarify so-called best interest standards for broker-dealers, cracked down on fraudulent cryptocurrency offerings and sought to ease barriers to capital raising.

These and related initiatives, all of which are still a work in progress, are likely to shape SEC priorities in 2019. Here are six regulatory developments to be on the lookout for.

### Regulation Best Interest

The SEC in April unveiled a long-awaited proposal that imposes a higher code of conduct for brokers when they are giving advice to retail investors. The coming year could see the contentious proposal become reality if enough commissioners are willing to back it.

Called Regulation Best Interest, the proposal requires brokers and advisers to disclose potential conflicts of interest, including if they are being paid by an investment company to promote a financial product that may not be in the best interest of a client. The proposal is touted as applying an elevated standard for brokers to ensure that investor clients are treated fairly.

Regulation Best Interest has also come under criticism by investor advocates because it doesn't go as far as to require a fiduciary standard — meaning a broker or adviser must put their clients' interest ahead of their own — unlike a prior Department of Labor proposal that was shot down by a circuit court. Critics of

the SEC proposal, including former commissioner Kara Stein, have also pointed out that the mammoth proposal doesn't clearly define what "best interest" is.

That said, lawyers following the proposal say Regulation Best Interest could represent the best chance

to raise standards on broker-dealers, a key goal of the architects of the Dodd-Frank law. Orrick Herrington & Sutcliffe LLP partner Daniel Nathan said the proposal could be seen as "fiduciary duty lite."

"Having come this far down the road, it's pretty tough to back down," Nathan said.

The proposal is targeted for adoption by September, according to the SEC. Its passage could hinge on who replaces Stein, a critic of the proposal, who planned to leave the SEC in December.

Stein, a Democrat, was the lone commissioner to vote against releasing the proposal for public comment in April. If her replacement is more welcoming to the idea, that could improve the odds of its passage, said Cadwalader Wickersham & Taft LLP partner Kyle DeYoung. He noted that other commissioners voted to introduce the proposal, but with varying degrees of reservation.

One of those commissioners, Republican Michael Piwowar, has since stepped down and was replaced by Elad Roisman, who has yet to take a position, saying he will scrutinize public comments. In any event, Clayton is expected to work aggressively to forge a consensus.

"If I am in Clayton's office, this is a pretty big proposal and a big part of his legacy," De Young said.

### **Possible Bitcoin ETF**

Against the backdrop of a turbulent cryptocurrency market, the SEC will decide in February the fate of a closely watched proposal to list the first bitcoin-backed exchange-traded fund. The SEC to date has rejected all bitcoin-affiliated ETF proposals on grounds that the underlying market for digital currencies are vulnerable to manipulation and pose risks to retail investors.

The backers of SolidX Bitcoin Shares, which would trade on the Cboe BZX Exchange Inc., have sought to ease SEC concerns by setting an estimated \$200,000 share price. Such a high entry point would presumably appeal to institutional investors and thus limit risk to retail investors.

The SEC in December delayed action on the SolidX proposal, which has drawn more than 1,600 comments, setting a final deadline of Feb. 27.

Cryptocurrency industry advocates see acceptance of a bitcoin ETF as necessary in gaining institutional acceptance, which could propel growth of this nascent asset class. The SEC has yet to be persuaded, but the agency did agree in August to reconsider the rejection of nine bitcoin-based ETFs and take a closer look at the matter.

DeYoung said there is a “feeling of inevitability” that a bitcoin ETF will eventually pass muster, though predicting when is hard. The recent plunge in bitcoin, which sank below \$3,500 a coin in December after soaring to nearly \$20,000 a year ago, also hangs over regulators.

“What happens in the market month to month doesn’t make things easier for them because there is a lot of volatility,” Nathan said.

### **More Guidance on ICOs**

Beyond bitcoin, the SEC has broader concerns about cryptocurrency-related funding ventures known as initial coin offerings, which mostly eluded regulation before 2017. The SEC has since taken the position that most ICOs resemble securities sales and will be regulated as such, basing its reasoning on a Supreme Court precedent that guides how a security is defined.

The SEC has fleshed out its position through several enforcement actions and public statements since 2017, using the historic framework of securities laws to crack down on illegal offerings.

“We will see more progressive enforcement and increasingly tough steps in that space,” said Stephen Crimmins, a former SEC enforcement lawyer and partner at Murphy & McGonigle PC.

The legal outlook on ICOs is still far from resolved. While courts have generally backed SEC arguments, a California federal judge in December denied the SEC’s bid for a preliminary injunction bid against cryptocurrency startup Blockvest LLC on the grounds that the agency hadn’t met its burden showing that tokens sold in the company’s ICO met the definition of securities.

The SEC has also made a priority in recent months of guiding issuers on how to conduct legal ICOs, instructing them to register their offerings and comply with laws that apply to public trading companies or seek an exemption from registration. But lawyers point out that the SEC has left many questions unanswered, including whether it will adopt its disclosure and reporting regime to accommodate novel products such as ICO tokens and the digital startups that issue them.

“The question is when are we going to start seeing more definitive statements or definitive rulemaking and orders?” Davis Polk & Wardwell LLP partner Joseph Hall said.

### **Private Offering Revamp**

Clayton has also said the SEC’s staff is working on a proposal to streamline an “elaborate patchwork” of exemptions that govern the private sale of securities, a market that has grown exponentially over the past decade and has made it easier for startups to raise money without going public.

“I doubt anyone would have come up with anything close to the complex system we have today if they were starting with a blank slate,” Clayton said in recent testimony to the U.S. Senate.

Clayton has also said the agency will consider whether the definition of an “accredited investor,” which determines who is eligible to invest in private securities by using financial thresholds like income or wealth, should be expanded to consider an investor’s sophistication.

Broadening the definition of an accredited investor would expand the population eligible to invest in private companies, enabling more individuals to buy stakes in fast-growing, albeit riskier, startups before they become public. The House of Representatives last July passed a bill expanding the definition of an accredited investor, though the Senate has yet to take it up.

“The notion that people should have more choice is a noble one,” Hall said. “But you have to remember that more choice comes without a lot of the regulatory safeguards people take for granted.”

### **Proxy Voting Reform**

Clayton has also indicated that reforming the current proxy system for voting on corporate elections is a “significant initiative” for 2019. The push follows a November roundtable in which the SEC heard from market participants concerned that the proxy voting process has become opaque and often fails to serve shareholder interests.

The SEC has also heard complaints from business groups arguing that proxy firms who advise shareholders on how to vote in corporate elections, which determine matters ranging from executive pay to environmental issues, sometimes provide inaccurate or conflicting advice.

The two major proxy firms, Institutional Shareholders Services Inc. and Glass-Lewis & Co., say they have robust disclosure policies to inform investors of potential conflicts and quickly correct errors if they occur. Apart from potential SEC action, the Senate in November introduced a bill that would regulate proxy firms as investment advisers and scrutinize conflicts of interest.

Clayton also said the SEC is reviewing whether the \$2,000 ownership threshold to submit a shareholder proposal, which was devised in 1998, and thresholds to resubmit a failed proposal, developed in 1954, are still applicable. Critics of the current standards argue that revisions are needed to prevent “zombie” proposals with little support from appearing on ballots.

While it’s unclear how much the SEC will tackle in 2019, Clayton has said staff is developing recommendations to improve the proxy process, prioritizing those that help long-term investors.

“Given the recent proxy roundtable, and some of the comments, it seems like that is at the top of the list,” Susan Resley of Morgan Lewis & Bockius LLP said.

### **Quarterly Reporting Under Review**

The SEC is also considering whether the quarterly system, in which public companies report earnings and make regulatory filings, should be revised in favor of a semi-annual system, or some other way that

reduces costs without depriving investors. The SEC in December invited public input on the matter amid a broader debate about whether markets are too short-term focused.

President Donald Trump amplified the debate in August, when he tweeted that the SEC should consider moving to a six-month system, saying “top business leaders” support the idea. Quarterly reporting has been the basis of U.S. disclosure policy since 1970.

The SEC hasn't given any sign of ditching quarterly reports for major companies, but Clayton has noted that quarterly reporting may not be appropriate for some smaller companies on the premise that “one size does not fit all.” All public companies currently release quarterly earnings statements to the market and also file a costlier and more comprehensive quarterly report with the SEC that describes their operations in greater detail.

Any proposal to reduce reporting frequency could face a hard sell with information-hungry U.S. investors accustomed to the three-month timetable in place for nearly 50 years. Hall, who advises companies, said he expects buy-side investors to oppose such a move, adding that those on the corporate side will offer arguments about how quarterly cycles impact decision-making.

“That will be a real, interesting debate and one that we should have,” Hall said.

--Editing by Philip Shea and Alyssa Miller.