



2024 | VOL. 28 | NO. 2

NY Business Law Journal

A publication of the Business Law Section of the New York State Bar Association

Regulating Artificial Intelligence:
Insights From NYDFS' Latest Guidance

Restoring Trust: The Role of the Cryptocurrency
Accountability Act in Government Transparency

SEC Adopts Major Changes to SPAC Rules



Business Law Section



Fellowship Program

The goal of the New York State Bar Association (NYSBA) Business Law Section (BLS) Fellowship Program (“the Program”) is to create a network and forge relationships which will foster greater diversity in law firms throughout New York State. Through the Program, Fellows will be provided a meaningful and appropriately supervised work experience by host law firms working in partnership with the NYSBA Business Law Section’s Membership & Diversity Committee.

Law firms will provide an opportunity for students to understand the business law practice, have an extra resource to assist with accomplishing goals and completing short-term assignments, and help develop a pipeline of talent for the practice of Business Law generally.

BLS will pay \$5,000 and the law firm will pay \$7,000 for a total of \$12,000 for the Fellows’ stipend.

The Committee will have an orientation meeting for the Fellows and firms prior to the start of the Program, periodic check-ins during the summer, and a wrap-up meeting at the conclusion of the Program.

Applications for students will close on Friday, February 28, 2025; BLS will inform firm of Program fellows by Monday, March 17, 2025; and inform students of firm placement by Monday, March 24, 2025.

Fellowship Program Details

Eligible Students

Students must be class of 2026 or 2027 attending a New York State law school, with a minimum GPA of 3.0 and capable of fulfilling the requested work hours and responsibilities during the summer of 2025 (in-person, hybrid, virtually to be decided by employer). Students will submit: 1) application form; 2) letter of interest (stating interest in practicing business law); 3) resume; 4) unofficial, current law school transcript and 5) writing sample (no longer than 10 pages).

Law Firm Requirements

The law firm will provide a 10-week Fellowship (maximum 40 hours per week from June – August); designate an attorney to serve as a Mentor who will work with, consult, advise, and guide the Fellow during the summer; exercise diligence and sensitivity to ensure that the Fellow works on meaningful assignments equivalent to those assigned to other young lawyers; evaluate and provide feedback to the Fellow and complete an evaluation of the Program and provide any information relevant to the Program requested by the Membership & Diversity Committee. The firm should also designate a contact person for the Committee.

Questions?

To participate in the program, please contact Taa Grays, Membership & Diversity Committee Co-Chair, at tgraysbarmail@gmail.com by Feb. 28, 2025.



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New York State Bar Association
In Cooperation With
Albany Law School

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NY Business Law Journal

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Message From the Chair

The role of business law is at an inflection point in New York as in the nation as a whole, and the challenge for business lawyers is to stay abreast of evolving and new trends and issues that impact society at large, as well as their clients in particular matters. The mission of the Business Law Section more than ever is to spread its net wide over the ever-expanding range of issues that affect business. As a section, we aim to recognize the larger issues affecting society and address how business law necessarily both relates to and is affected by those issues. We should be mindful of the very purposes of NYSBA, which include “to promote reform in the law” and “to facilitate the administration of justice.”

Why is this time in particular an inflection point? What is different today as opposed to other times? Don't trends come and go?

The answer is that, to a greater extent than ever, businesses are expected to serve a broader range of constituencies than just their shareholders. The success of business enterprises thus increasingly depends on how effectively they respond to societal concerns, ranging from the explosive growth of technology and the challenges as well as the opportunities it creates, to environmental protection, promoting diversity, equity and inclusion in the workplace, and myriad other societal goals. As business lawyers, it is incumbent on us not just to advise our clients, but to be proactive in helping to shape the laws that govern them. I am not suggesting that business lawyers drive or should drive such debates. But business law is a key plank in the legal structure of the economy, and how we as business lawyers guide our clients in responding to these concerns inevitably will influence how these debates are shaped going forward.

One prominent example is how business law will respond to the challenges of artificial intelligence (AI). The Business Law Section has conducted a series of programs on AI and contributed an article to be published in the New York Law Journal reviewing the state of regulation (or lack thereof) over AI, with a tip of the cap to Luca Melchionna, chair of our Technology and Venture Law Committee. Our upcoming Annual Meeting, to be held in conjunction with the Corporate Counsel Section, will include a panel on AI. As we pointed out in that article, subjects at stake in the development of AI include democratic processes, privacy, cybersecurity, employment discrimination, ethics, disinformation, and intellectual property rights. Given the extensive development of AI in the business world, the challenge of business law is



to appropriately address and accommodate those subjects as regulation also develops.

Our section has also tracked and spoken out on developments in non-competition covenants, as the Federal Trade Commission (FTC), New York, and other states have adopted or proposed a variety of laws and rules to restrict or otherwise regulate the use of non-competition covenants by businesses. Developments continue in this area, as the FTC rule has been challenged in court. As reflected in our own discussions and analysis on the subject, the apparent increasing use of non-competition covenants has raised particular issues of the ability of individuals to progress in their careers, the need for businesses to protect their investment in their products, services, and employees, and the interest of society in having an economy that provides meaningful opportunities for all participants in the economy, not just the holders of capital. More general issues such as reported increases in income inequality will continue to stoke debate on the nature and purposes of business practices, not just the use of non-competition covenants.

Part of the societal debate about business in general is the specific role of governmental regulation. With the Supreme Court having overturned the long-standing *Chevron* doctrine (see HeadNotes in this issue), federal courts are no longer expected – indeed, are expressly no longer permitted – to defer to agency decisions and interpretations of applicable law. This both opens the door to fresh challenges of agency actions by affected businesses and other parties and creates new challenges for the agencies charged with implementing the underlying laws. The pending year-end deadline for the first year of the full effect of the federal Corporate Transparency Act, which requires reporting of personal information of business owners in order to combat money laundering, is yet another current reminder of the continuing evolution of

government regulation. The incoming Trump administration has heralded a further re-examination of the role of government and law itself in maintaining the “rules of the game” for civil society in general and business in particular.

A large sector of the economy in New York is the charitable sector. There are tens of thousands of charities in New York and an estimated 1.8 million across the country. New York and federal law also comprehensively regulate this sector. As a section we have seen and addressed continuing challenges in this area of law, through our Not-For-Profit Corporations Law Committee and our Legislative Affairs Committee. One example is pending litigation challenging the federal prohibition of charity participation in political campaign activity. Although that prohibition has been firmly in place for many decades, with every election cycle the public debate renews, with calls equally to enforce it firmly as well as to repeal it. Nonprofit law is a unique area of business law in that its focus is directly on public benefit rather than creating value for shareholders. The nonprofit sector is second only to the governmental sector in the express promotion of public benefit, but through independent nonprofits instead of centralized programs. And since nonprofits are also substantial enter-

prises with significant employment and assets, they also contribute importantly to local and regional economies and thus in many respects operate like businesses. Thus, regulation of nonprofits balances the desire to promote public benefit with the need to uphold accountability for the use of charitable resources.

Finally, the recent elections appear to be reflective of seemingly deepening divisions in society over economic and social issues as well as heralding potentially dramatic changes in law and regulation.

The challenge for business lawyers and this section is to apply our skills to the improvement of business law in light of all the larger issues that business law both affects and is affected by. The rapid pace of change in so many areas is what makes this time look like an inflection point for business law. We should prepare ourselves to respond.

Michael A. de Freitas

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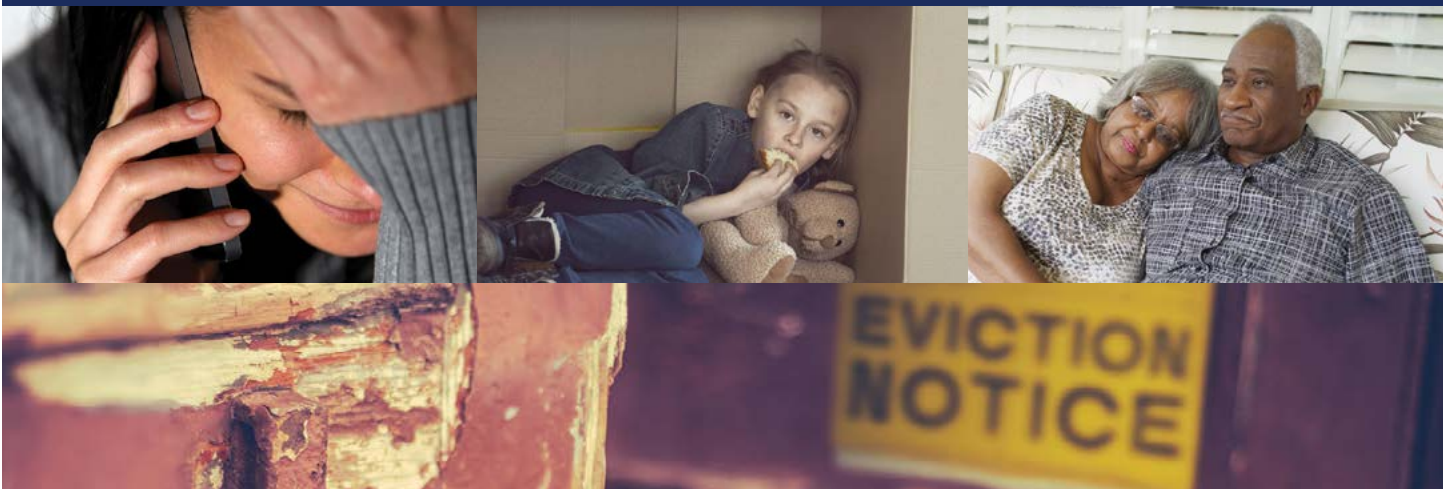
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HeadNotes

Since our Summer 2024 issue was published, two events have occurred that herald a sea change in the way businesses of all types will interact with their regulators – and pose new and different challenges for their counsel. The first, of course, is the election of Donald Trump to a new term as president. The second is the Supreme Court’s decision, announced at the end of its term in June, overturning the *Chevron* doctrine,¹ which required the federal courts to defer to decisions by the federal agencies in interpreting ambiguities in the laws they administer.

The incoming president has publicly pledged to take an ax to the federal bureaucracy and has proposed the creation of a new Department of Government Efficiency (DOGE), to be run by Elon Musk, the world’s richest man, and Vivek Ramaswamy, a biotech investor and former Republican presidential candidate. These men have proposed massive cuts to the federal budget, but neither has any experience with the federal bureaucracy, and the incoming president has expressed opposition to cuts in entitlements such as Social Security and Medicare. Of course, the DOGE would have no power to directly implement any budget cuts, which would still have to go through the Congressional budget process – and in an environment where the Republican majority in the House is razor thin.

Mr. Trump also is a big supporter of crypto currencies and has pledged to “fire” SEC Chairman Gary Gensler, a strong advocate for crypto regulation, on day one of his administration. Whether he can “fire” an SEC commissioner is debatable, but he certainly can choose one of the sitting Republican commissioners to replace Gensler as chair, or install a new chair if there is a vacancy on the commission. And when the chair of a major federal agency is replaced, usually he or she will resign from the agency – as Janet Yellen did in 2018, when then-President Trump declined to reappoint her as chair of the Federal Reserve Board of Governors. Mr. Trump is also likely to rescind many of President Biden’s executive orders, and to ask Congress to rescind portions of the Inflation Reduction Act passed during the Biden administration, which among other things provides for “green” initiatives such as subsidies for sustainable energy – although it is not clear at this writing whether this can be accomplished, as some portions of the act have support among various Republicans in the House and Senate. And, of course, Mr. Trump has consistently proposed massive tariffs, including on our two leading trade partners, Canada and Mexico, as well as China and others, which at the least could significantly disrupt existing supply chains and stoke inflation by increasing



the cost of imported goods – by one estimate, an average of \$1,500 annually per household. Mr. Trump’s stated intention to deport millions of illegal aliens, if implemented, certainly would be disruptive in an already tight labor market. Agricultural and service companies especially stand to lose large numbers of workers, and there would likely be upward pressure on wages and prices.

More generally, Mr. Trump has taken the stance, as expressed by his White House counsel during his first administration, that “the ever-growing, unaccountable administrative state is a direct threat to individual liberty.” A study by Cato, the libertarian think tank, concluded that the flow of new regulations was significantly slower in his first term than in that of his immediate predecessors, and that his first administration was at least somewhat effective working with Congress to remove some regulatory impediments – but also that at least some of his deregulatory intentions, especially in the environmental area, were blocked by the federal judiciary.² It can be expected, of course, that his new administration will focus on appointing federal judges who will be sympathetic to his deregulatory agenda, but nonetheless it can also be expected that the overturning of the *Chevron* doctrine will lead to a flood of new litigation challenging a range of regulatory actions. Early in 2024, in anticipation that *Chevron* would be overturned, the federal courts were already said to be planning for how to handle the expected inflow of new cases against federal agencies.

On the regulatory side, the elimination of *Chevron* deference could, ironically, actually hamper the incoming administration’s efforts to overturn regulations promulgated by the federal agencies. In the *Chevron* case in 1984, the Supreme Court unanimously held that the federal courts are required to defer to agency interpretations of ambiguous provisions of the statutes they administer, as long as the agency’s interpreta-

tion was reasonable and not inconsistent with the governing statute. In overturning this well-settled precedent the Court's ruling earlier this year held, in effect, that deference to agencies under *Chevron* was inconsistent with the mandate under the Administrative Procedure Act that the court itself must decide all questions of law.³ However, the Court also made clear that the doctrine of statutory *stare decisis* remains in effect – i.e., settled case law regarding agency interpretations remains valid, even if the court followed the *Chevron* doctrine by deferring to the agency's interpretation of the law. So it appears that if an agency were now to abruptly change course on its own settled interpretation of law it will face a heavy burden if challenged in court. And the Court also made clear that the *Skidmore* doctrine,⁴ which permits the courts to give great (but not conclusive) weight to agency decisions, remains in effect – i.e., the court may be “persuaded” (but not bound) by the thoroughness evident in the agency's consideration, the validity of its reasoning, and its consistency with earlier and later pronouncements. Given the complexity of so many of these laws, and the presumed expertise of the agencies charged with enforcing them, it seems likely that in at least some cases the courts will follow, without deferring to, agency interpretations that meet the *Skidmore* criteria. So in the end, the massive changes in regulatory policy sought by the incoming administration may be more difficult to achieve in practice.

Meanwhile, plenty of challenges await businesses and their attorneys as we enter the new year. Leading off this issue, the attorneys of Sullivan & Cromwell set the stage with “Hot Topics for Boards and Committees.” At the board level, bringing directors up to speed regarding artificial intelligence (AI) and how to manage the risks and opportunities it presents may be foremost on the agenda for many companies; other salient issues are management succession planning, monitoring the compliance culture, improving coordination among board committees dealing with different areas, and monitoring the business impact of emerging political, regulatory, and social trends – not the least being, of course, the new administration, but including a number of recent Delaware and federal cases. At the committee level, hot topics include cyber incident response and other audit and risk committee issues, as well as issues for compensation committees and nominating and governance committees. Though focused on public companies, in most areas their guidance is equally relevant for smaller businesses as well – and essential for attorneys charged with advising business clients. We are grateful to the attorneys of Sullivan & Cromwell for sharing their knowledge and insights with our readers.

It is evident that cybersecurity is, or should be, at the top of the “hot topics” list for nearly every business and its counsel. At the federal level, the financial institution regulators

in particular have been grappling with how to mitigate the special risks presented by institutions entrusted with handling sensitive customer information. In 2023 the Securities and Exchange Commission (SEC) proposed, and in 2024 adopted, amendments to its Regulation S-P, which generally governs privacy and safeguarding of customer information, applicable to financial intermediaries under its jurisdiction, including broker/dealer firms, investment companies such as mutual funds, registered investment advisers and transfer agents (including those registered with other agencies) and crowdfunding portals under Regulation Crowdfunding. In “SEC Adopts Cybersecurity-Related Amendments to Regulation S-P for Market Participants,” Ronald Feiman and Matthew Dunn explain in clear and practical terms what is required under the amended regulation, including a written incident response program, policies and procedures to implement the program, and rules for notification of customers when an incident has occurred. Even attorneys who do not practice in the securities area are well advised to be up to speed on the new SEC rules, as cybersecurity measures adopted in one industry are likely to be adopted by others as well. Messrs. Feiman and Dunn are partners of Carter, Ledyard & Milburn LLP in New York City.

As the financial capital of the world, New York State has often been at the forefront of regulatory responses to emerging trends and issues, and cybersecurity is no exception. In 2017 New York became the first state to directly involve itself in the oversight of cybersecurity incidents and how they are managed by financial institutions, as the New York State Department of Financial Services (DFS) promulgated Part 500 of its regulations (23 N.Y.C.R.R. Part 500) (“Part 500”). The DFS at the time asserted that Part 500 was promulgated in response to deficiencies its examiners had identified in the cybersecurity programs of the institutions it regulates – which include a wide range of “covered entities” that are licensed or supervised by the DFS. With artificial intelligence having come to the fore as an emerging business trend, in October 2024 the DFS released an Industry Letter addressing the application of Part 500 to AI. In “Regulating Artificial Intelligence: Insights From NYDFS' Latest Guidance,” Carly Nixon reviews the background and history of Part 500, then discusses the new Letter, which asserts that AI is being used to leverage the effectiveness of cyber attacks in two primary ways: through AI-enhanced social engineering, such as sophisticated “deepfakes” that create realistic audio and video intended to deceive recipients, and AI-enhanced cybersecurity attacks, which use AI to identify and exploit vulnerabilities. The author reviews and explains the six specific ways proposed by the DFS to mitigate AI-related risks. She notes that while the Letter does not change the requirements of Part 500 itself, it may presage forthcoming amendments to Part 500 to more directly address AI-related risks to cyberse-

curity. Ms. Nixon is an associate with Lowenstein Sandler in New York City.

Another technology-related issue likely to remain at the forefront over the next year is the use and regulation of cryptocurrency, of which the best known is bitcoin – whose value has reached record highs recently, reflecting the presumed propensity of the incoming administration to lessen or remove regulatory impediments to its use. From the government’s perspective, of course, the burgeoning use of crypto carries with it the potential for illegal activities, such as money laundering and tax evasion. In 2022 President Biden issued an executive order initiating a wide-ranging review of crypto assets and empowering federal agencies to scrutinize digital currencies and evaluate their potential impact on financial stability generally. But “physician, heal thyself,” as the saying goes; under existing law the potential exists for members of the Congress to conceal crypto assets – even as recent legislation mandates disclosure of securities holdings. In “Restoring Trust: The Role of the Cryptocurrency Accountability Act in Government Transparency,” Julia Vavrinec focuses on proposed new legislation, arguing that enactment of the Cryptocurrency Accountability Act would increase public trust by assuring that members of the Congress and their staff would be held to essentially the same disclosure requirements that apply to members of the executive branch, and that are applied by the Internal Revenue Service to all taxpayers. Along the way she provides a clear and cogent explanation of digital currencies and how they operate – recommended to our readers who are seeking a better basic understanding of this burgeoning new market – as well as a thorough and well-researched background on the history and development of government ethics laws. Shortly before publication she provided an addendum to her article, discussing the probable impact of the incoming Trump administration on crypto disclosure initiatives. Ms. Vavrinec is a third-year student at Albany Law School.

In recent years the use of SPACs – special purpose acquisition companies – to effect merger and acquisition transactions has exploded. A SPAC can issue securities through an initial public offering (IPO) to raise money for the prospective acquisition of or merger with an existing company. This raises unique disclosure challenges for SPACs and their counsel in dealing with the Securities and Exchange Commission. In “SEC Adopts Major Changes to SPAC Rules” the attorneys of Carter, Ledyard & Milburn discuss new rules promulgated by the SEC in 2024 aimed at enhancing disclosure for investors in SPAC IPOs – as well as for subsequent transactions in which the SPAC effects a merger or acquisition with a target company (a “de-SPAC” transaction). Among other things, the new rule requires enhanced disclosure regarding the sponsors of the SPAC, including their background and experience and any conflicts of interest. On the de-SPAC side, greater dis-

closure will be required regarding the determination by the SPAC Board that the transaction is in its best interests, and any outside appraisals or opinions that were sought regarding the fairness of the transaction. The SEC also declined to provide a blanket exemption for SPACs under the definition of “investment company” under the Investment Company Act of 1940 – potentially exposing them to the possibility of being required to register under that act. As always, Guy Lander and his colleagues at Carter, Ledyard & Milburn provide a clear and concise explanation of a complex area of securities law. Mr. Lander is a past chair of the Business Law Section and a member of the Journal’s Advisory Board.

Given its intended deregulatory bent, it would not be surprising if the incoming administration sets its sights on overturning recent actions of the Biden administration aimed at making bank mergers more vulnerable to attack under both antitrust and banking law. The application of antitrust laws to bank mergers has a long and convoluted history. In 1960 Congress passed the Bank Merger Act (BMA), with the apparent intention that the BMA rather than the antitrust laws would govern bank mergers, but four years later the Supreme Court held that the antitrust laws as well as the BMA remain fully applicable.⁵ The agency that will have primary jurisdiction over the resulting bank post-merger – the Office of the Comptroller of the Currency (OCC) for national banks, the Federal Reserve (“Fed”) for all bank holding companies and state-chartered banks that are Fed members, and the Federal Deposit Insurance Corporation (FDIC) for the (mostly small) state banks that are not Fed members – has ultimate authority to approve or disapprove the merger, but must consult with the other regulators and the Department of Justice (DoJ) before deciding.

Pursuant to a 2021 Executive Order by President Biden, the agencies have now put forward revised merger guidelines intended to increase the level of antitrust enforcement activity in the banking industry. In “Coordinated DOJ, FDIC and OCC Final Actions on Bank Merger Policy,” the attorneys of Sullivan & Cromwell provide a comprehensive overview of the development of bank merger policy and show how the revised new policies represent a dramatic shift in antitrust enforcement policy toward banks. Among other things, the DoJ scrapped its Bank Merger Guidelines, in effect since 1995, and will now treat bank mergers under its general Merger Guidelines promulgated in 2023, but in so doing it also provided an addendum clarifying how the 2023 Guidelines are to be applied to the banking industry – most dramatically, lowering the threshold under the Herfindahl-Hirschmann Index (HHI), a measure of market concentration, to consider a bank merger anticompetitive. Perhaps most significantly the Fed, which is the agency with the most experience in merger transactions since it oversees all bank holding com-

panies, did not join the other agencies, raising the potential of a divergence of approach.

In recent litigation under the Private Securities Litigation Reform Act (PSLRA), the federal Circuit Courts have split on two key questions: whether plaintiffs who use internal corporate documents to allege scienter must plead with particularity what those documents will show, and whether plaintiffs may use expert witnesses to substitute for particular fact allegations. In November the Supreme Court heard oral arguments aimed at harmonizing the split between the Circuits; however, the Court unexpectedly dismissed the case on December 11, leaving those different standards in effect for now. In “Supreme Court Mulls What PSLRA’s ‘Particularity’ Standard Requires,” Mark R.S. Foster and Virginia Milstead review the relevant case law in the Ninth Circuit and illustrate how it is in conflict with decisions in the Second and other federal Circuit courts, and the implications of these different approaches for pleading requirements in cases brought under the PSLRA. Mr. Foster and Ms. Milstead are partners at Skadden Arps in New York City.

Concluding this issue is the incomparable “Inside the Courts,” a comprehensive and concise guide to substantially all litigation taking place in the federal courts that involves securities, general corporate law, and a wide range of additional matters. Even for business attorneys who are not themselves litigators, “Inside the Courts” is an invaluable heads-up on potential changes in the law that could affect their clients. For

more than a decade our readers have had the benefit of this exceptional resource. We remain, as always, grateful to the attorneys of Skadden Arps for their willingness to share their knowledge and expertise with their colleagues in the New York business bar.

David Glass
Editor-in-Chief

Endnotes

1. *Chevron USA, Inc. v. Natural Resources Defense Council*, 467 US 837 (1984).
2. Keith B. Belton and John D. Graham, *Deregulation Under Trump*, Cato Institute, Summer 2020, <https://www.cato.org/regulation/summer-2020/deregulation-under-trump#findings>.
3. *Loper Bright v. Raimondo*, No. 22-451, 603 US ____ (2024).
4. *Skidmore v. Swift & Co.*, 323 US 134 (1944).
5. *United States v. Philadelphia Nat'l Bank*, 374 US 321 (1963).

NEW YORK STATE BAR ASSOCIATION

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Articles should be submitted in electronic document format (pdfs are NOT acceptable), along with biographical information.

REQUEST FOR ARTICLES



Hot Topics for Boards and Committees

By the Attorneys at Sullivan & Cromwell

The following topics are likely to be on the agenda for public company boards and board committees in the coming year. While we have organized these topics into separate sections for the board and its audit, compensation and nominating and governance committees, the appropriate governing body for introducing these topics will vary from company to company depending on how oversight responsibilities are allocated by the board.

Board Agenda Topics

Addressing the Use of Artificial Intelligence

Many boards are seeking to increase their directors' understanding of AI, how management and their third-party service providers use or plan to use it, any compliance obligations and the potential related risks and opportunities. Some companies that rely on AI for material services or operations are, with board oversight, developing frameworks to govern their use of AI, including policies, guidelines and internal controls to ensure AI use complies with the company's goals and legal, regulatory and ethical obligations. Some companies are also reviewing their disclosures and other public statements regarding the use of AI in light of the SEC's announced focus on AI-related fraud, including "AI washing" (see, e.g., the SEC's recent complaint against Joonko for securities fraud based on alleged misrepresentations regarding its use of AI, among other things).

Overseeing Management Succession Planning

Consistently high rates of CEO turnover in recent years, as well as the potentially significant costs of a poorly managed transition and activist attention on succession issues, has led to greater focus by boards to demonstrate that they have robust CEO succession planning processes in place. Although there is no "one size fits all" approach to succession planning, institutional investors and proxy advisors generally expect these processes to include: (a) plans for both unexpected and expected departures; (b) formal delegation of planning oversight to a board committee or director working group, with regular board-level discussion; and (c) consideration of both internal and external candidates. Many boards have also expanded their succession planning efforts to include other c-suite positions, such as CFO (whose unplanned departure can disrupt or delay earnings announcements and financial reporting schedules).

Monitoring the Company's Compliance Culture

Effective board-level oversight of corporate compliance is more important than ever in the wake of increased regulatory requirements, more aggressive regulatory enforcement actions and a steady uptick in *Caremark* claims based on alleged oversight failures (and a seemingly higher standard applied by the Delaware courts for "regulated" companies). In recognition of the key roles that corporate culture and the "tone at the top" can play in supporting and promoting legal/regulatory compliance, ethical behavior and accountability throughout companies, some boards are beginning to expand the scope of their corporate compliance reviews to include assessments of their company's culture. This may include periodically reviewing cultural and behavioral data from human resources and legal (e.g., employee surveys, turnover/absentee rates, exit interviews, whistleblower hotline data and summaries of recent misconduct investigations) and/or having a cultural audit conducted in order to understand the kinds of behaviors and attitudes that have developed throughout the organization. If any concerns are identified through these reviews, the board should consider whether a change in policy or enforcement may be appropriate.

Improving Committee Coordination

Companies are facing increasingly complex economic, geopolitical and regulatory environments, which can present risks to multiple aspects of their businesses and operations. Because effective oversight of these issues may require input from multiple board committees, some boards are finding it necessary to develop more holistic approaches to oversight that encourage greater information sharing and coordination between committees with potentially interrelated responsibilities (e.g., ESG and human capital management, cybersecurity and regulatory compliance). Although the right balance will vary by company and issue, potential options for enhancing committee coordination on relevant issues may include: (a) establishing practices/procedures that promote a minimum amount of discussion or reporting between applicable committees; (b) maintaining overlapping committee memberships; (c) periodically conducting joint committee meetings on topics of significance to multiple committees; and/or (d) having committee chairs provide updates to each other between meetings. At the same time, in light of stockholders' increased use of DGCL (Delaware General Corporation Law) § 220 books and records demands and *Caremark* lawsuits to challenge corporate oversight

processes over the last few years, any relevant communications or decisions between or by committees should continue to be made in compliance with applicable board/committee procedures and kept to formal channels.

Monitoring the Business Impact of Emerging Trends

Political, regulatory, economic and social conditions have continued to fluctuate over the last few years, making it important for boards to stay apprised of new developments that could materially impact their company's strategic plans or operations. The first half of 2024 alone has seen active regulatory rulemaking and enforcement, increased polarization of ESG issues, continued antitrust scrutiny of M&A transactions and a number of important Delaware and federal court decisions that have impacted various aspects of corporate governance – all of which has created significant uncertainty for companies. Moreover, as the U.S. presidential election approaches, uncertain market and regulatory conditions have intensified even further. To address and manage risk in a rapidly changing environment, some boards are requesting more frequent updates from management on key developments. Some boards are also asking management to review and test the assumptions and sensitivities underlying their company's strategic plans to take account of different potential scenarios.

Audit/Risk Committee Agenda Topics

Reviewing Cyber Incident Response Plans and Disclosures

Corporate procedures for identifying and reporting cyber incidents and risks are under even greater scrutiny following the now-effective Form 8-K reporting requirements for material cybersecurity incidents as well as the SEC's recent enforcement actions seeking to hold companies liable in the aftermath of cyber-attacks (see, e.g., the SEC's settlement with R.R. Donnelley (alleging that the company failed to maintain adequate controls to prevent and enable a timely response to a 2021 ransomware attack) and ongoing action against SolarWinds (charging the company and its CISO with fraud and internal control violations for allegedly misleading investors about known cybersecurity weaknesses and risks)). While most of the SEC's charges in *SolarWinds* were recently dismissed by the U.S. District Court for the Southern District of New York, including the SEC's efforts to use its "internal accounting controls" authority to support an enforcement action based on non-financial/accounting cybersecurity controls, the court allowed the fraud claims involving an allegedly misleading website statement about the company's cybersecurity practices to survive. These cases underscore the importance of understanding company processes and procedures for identifying and escalating potentially significant cybersecurity incidents and risks, for purposes of both ensuring timely disclosure and enabling the board to exercise appropri-

ate oversight and governance of such matters. See Sullivan & Cromwell's memos on the recent *SolarWinds* decision and the R.R. Donnelley settlement for more information.

Considering Proposed NOCLAR Amendments

On June 6, 2023, the PCAOB (Public Company Accounting Standards Oversight Board) proposed amendments to its auditing standards that would expand the scope of auditor responsibilities with respect to identifying, assessing and communicating a company's noncompliance with laws and regulations (NOCLAR). The proposed amendments have received significant criticism, prompting the PCAOB to hold a virtual roundtable and reopen the comment period for the amendments earlier this year. However, the PCAOB has indicated that it still expects to adopt final NOCLAR amendments during 2024, although it is widely expected that any final amendments will be substantially revised. Audit committees should consider the potential impact of any final amendments on their company's existing processes for monitoring legal and regulatory compliance.

Determining Management's Climate Preparedness

Institutional investors, proxy advisors, stockholders and other stakeholders have long requested that companies voluntarily provide climate-related data. However, the last few years have also seen a proliferation of federal, state and international rules and standards seeking to mandate and standardize disclosure of climate-related information, including the SEC's climate disclosure rules, California's climate reporting laws and the EU's Corporate Sustainability Reporting Directive, among others. Because each of these regulations impose different disclosure obligations and deadlines, companies may want to work with counsel and consultants to determine which regulations will apply to them and develop a coordinated multi-jurisdictional compliance strategy. Some audit committees are also working with management to assess how prepared their companies are to comply with the applicable requirements (including the financial statement disclosure requirements under the SEC climate rules, if and when they take effect), including by discussing the processes, resources and controls that are (or need to be) in place for management to gather, organize, calculate, verify and report the necessary information. It is also important for companies to review their existing ESG-related disclosures and ensure appropriate support exists for any claims, particularly in light of the SEC's recent greenwashing enforcement actions (see, e.g., the SEC's settlement with Keurig). Additionally, companies that participate in, or are considering participating in, climate-related industry groups or similar initiatives to advance their ESG goals should be aware that collaborative ESG efforts may raise antitrust or other legal issues. For example, Republican state attorneys general and members of Congress have issued letters and investigative demands arguing that certain ESG initiatives, such as participation in the net zero alliance, may violate competition laws, and antitrust administrators under the Biden administration have stated that there is no ESG exception to U.S. antitrust laws. Companies should make efforts to follow appropriate guardrails when exchanging ESG-related information, particularly with companies in the same sector.

Compensation Committee Agenda Topics

Monitoring Developments Regarding the FTC's Non-Compete Ban

On April 23, 2024, the FTC issued a final rule banning employers from entering into new – or enforcing existing – non-compete agreements with their employees. Although this rule was scheduled to go into effect on September 4, 2024, the U.S. District Court for the Northern District of Texas issued a ruling on August 20, 2024 that currently prevents the new rule from taking effect nationwide. However, the FTC has the option to appeal the decision and it can still seek to prohibit non-competes on a case-by-case basis (as it has done over the last few years). As a result, companies may maintain the status quo with respect to these agreements, adhering to the patchwork of state limitations on the use of restrictive covenants. However, compensation committees should continue to monitor future legal developments with respect to the FTC's ban. *See Sullivan & Cromwell's* memos on the FTC's non-compete ban and the recent Texas decision for more information.

Reviewing Potential Whistleblower Restrictions

The SEC has demonstrated an increased focus on protecting whistleblowers in recent years, including by bringing a record number of enforcement actions, with significant financial penalties, based on alleged violations of Rule 21F-17 (which prohibits employers from taking actions that could impede individuals from communicating potential securities violations to the SEC). Employment practices that the SEC has asserted may violate Rule 21F-17 include: (a) broad confidentiality covenants that do not have carve-outs for whistleblower activity; (b) requiring employees to waive a right to monetary recovery as a whistleblower; (c) requiring notice or preclearance with the company before or after communicating with a regulatory agency; and (d) requiring representations in employee releases that the former employee has not filed any complaints or charges against the company. The CFPB has also recently released guidance warning that the use of overly broad confidentiality agreements with employees may violate the Consumer Financial Protection Act. As the SEC and other regulators continue to take aggressive approaches to enforcing whistleblower protections, compensation committees may want to oversee a review of employment agreements, employee handbooks, separation agreements, and other confidentiality provisions to ensure compliance with the SEC's broad interpretation of Rule 21F-17(a). *See Sullivan & Cromwell's* blog post regarding the CFPB's recent guidance and other related posts for more information.

Reassessing Clawback Policies

After the NYSE and Nasdaq clawback rules requiring listed companies to mandate recoupment of performance-based

executive compensation in the event of financial restatements went into effect last year, BlackRock, ISS and Glass Lewis each expressed their view that clawback policies should go further and permit recoupment in cases when there is evidence of problematic decisions or actions, such as material misconduct or operational failures. Compensation committees that are considering whether to expand their policies to include additional triggers may find it beneficial to review peer policies (including the level of specificity used and the amount of discretion given), the voting guidelines of key investors and stakeholders and any applicable state law restrictions. Compensation committees should also be aware of the recently re-proposed joint rule from the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Federal Housing Finance Agency and the National Credit Union Administration regarding incentive-based compensation arrangements at certain financial institutions with at least \$1 billion in assets. Among other things, the proposed rule would subject a covered executives' incentive compensation to recovery for at least seven years after vesting if he or she engaged in misconduct that resulted in significant financial or reputational harm to the institution, fraud or other bad acts. However, because the proposed rule also requires approval from the Federal Reserve and the SEC, there is significant uncertainty as to whether this proposal will progress through the rulemaking process.

Reviewing Insider Trading Policies

On April 5, 2024, a civil jury validated the SEC's "shadow trading" theory of insider trading liability after finding an executive guilty of insider trading when he used material non-public information about one company to trade in the securities of another, unrelated peer company. In response to this case, some compensation committees are considering whether they should update their companies' insider trading policies to include prohibitions on shadow trading, particularly in light of the SEC's recent rule requiring companies to file their insider trading policies with their annual reports. In deciding whether to revise their policies, relevant factors compensation committees may want to consider include: (a) the nature of the company, including its size and industry; (b) how the company's insider trading policy is currently drafted, including whether it applies to affiliates of directors, officers or employees; and (c) whether there are other policies – such as information barrier policies – that would restrict shadow insider trading.

Nominating and Governance Committee Agenda Topics

Reviewing Nomination Requirements

Over the last year, plaintiffs' firms have brought numerous legal challenges against companies based on their nomination-

related governance policies, including advance notice bylaws, director qualification requirements and director resignation policies. However, such challenges may subside in the coming months following the Delaware Supreme Court's recent decision in *Kellner v. AIM ImmunoTech Inc.*, which generally confirmed the enforceability of advance notice requirements so long as they are: (a) adopted on a "clear day"; (b) facially valid (i.e., consistent with the certificate of incorporation, not prohibited by law and addressing a proper subject matter); (c) unambiguous; and (d) applied reasonably. In contrast, bylaws that are indecipherable or adopted and/or applied on a "cloudy day" (e.g., during a proxy contest) will be subject to "enhanced scrutiny" review. As a result, nominating and governance committees may still want to review their bylaws and nomination requirements to assess potential risks and consider potential opportunities to refine those policies on a "clear day" (as needed).

Verifying Director Qualifications

In response to the heightened scrutiny of individual director qualifications following the adoption of the universal proxy rules and other recent developments, companies are increasingly using skills matrices to demonstrate that their directors have the necessary skills and qualifications to exercise effective oversight. However, some investors have criticized "over-checked" skills matrices in which directors are listed as having certain skills despite not having meaningful or recent experience in those areas. To address these concerns, some nominating and governance committees are conducting more rigorous reviews of self-identified qualifications to ensure that appropriate support exists for any listed skills (usually through questions contained in their company's D&O questionnaire). In deciding which relevant skills to highlight, companies may also want to consider the possible use of AI by institutional investors and other governance stakeholders to analyze information from skills matrices for purposes of assessing director qualifications. Additionally, when reviewing director qualifications, nominating and governance committees should also be mindful of potential overboarding, conflict of interest and Clayton Act interlocking directorate considerations with respect to directors' outside board memberships and other affiliations given heightened investor and regulatory scrutiny (particularly by the Department of Justice) of these matters.

Assessing Board Education Opportunities

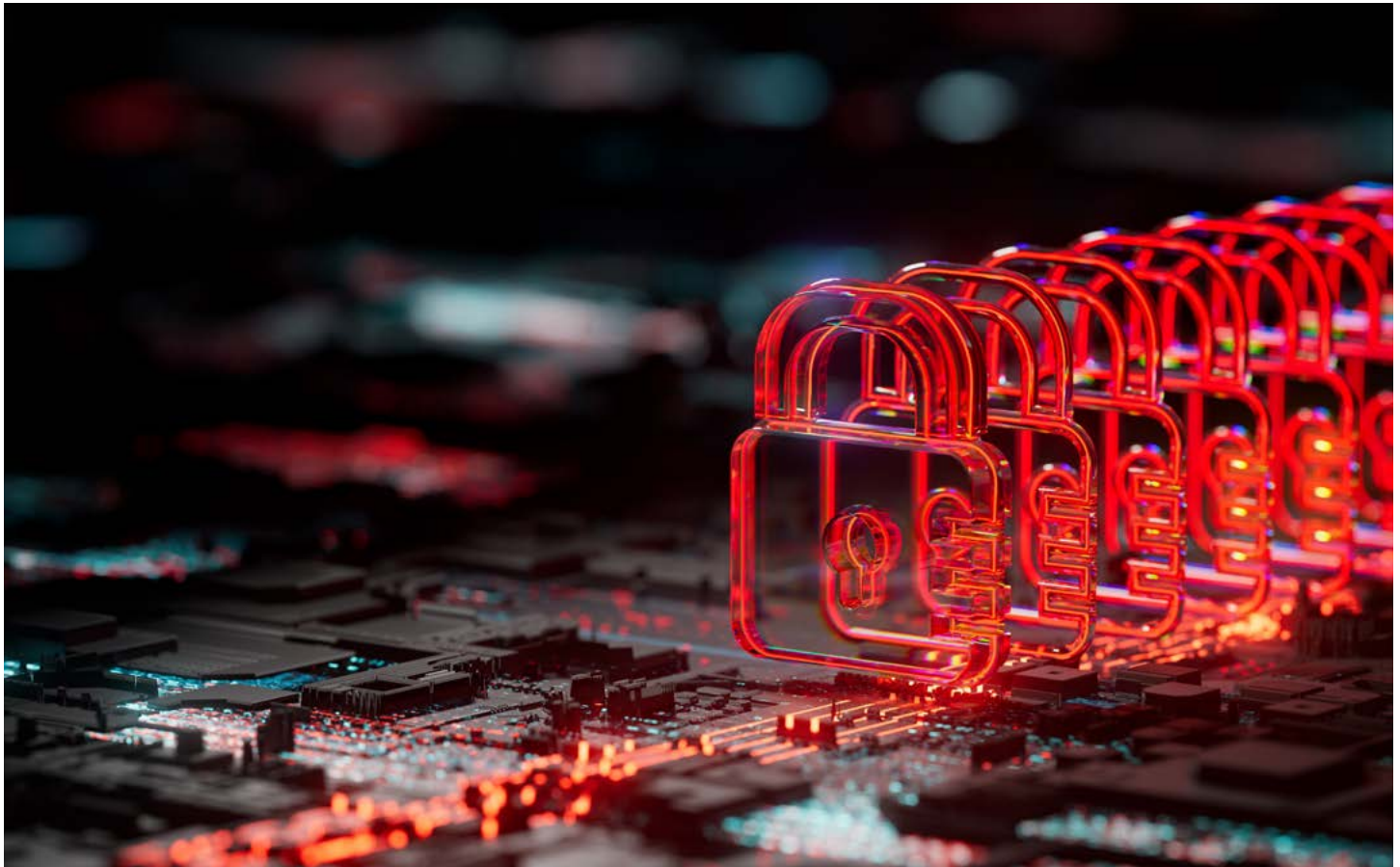
As board oversight responsibilities continue to expand to cover new and emerging issues, ensuring directors have sufficient knowledge to provide guidance and oversight is becoming more challenging. Although some nominating and governance committees are prioritizing the appointment of directors with specialized expertise to address potential skills gaps, others are focusing on alternative ways to provide the board with the necessary knowledge, including hiring external consultants, holding director education sessions (hosted by management or a third party) and/or establishing advisory councils. Different topics may warrant different approaches, and factors such as the topic's complexity and significance to the company, whether it is the responsibility of the board or a committee and the current level of director knowledge on a particular topic should likely be considered in determining the most appropriate approach.

Additional Sources of Information

- For an analysis of the significant trends and developments in Rule 14a-8 proposals and compensation-related matters during the 2024 proxy season, see Sullivan & Cromwell's 2024 Proxy Season Review.
- For information regarding the recently adopted amendments to the DGCL, which took effect on August 1, 2024, see the Delaware State Legislature's summary of changes.
- For S&P 500 board composition and governance data and trends, see Spencer Stuart's latest U.S. board index.
- For the results of a survey on institutional investor priorities for 2024, see EY's report on what directors need to know about the 2024 proxy season.

SEC Adopts Cybersecurity-Related Amendments to Regulation S-P for Market Participants

By Ronald M. Feiman and Matthew D. Dunn



Fourteen months after it proposed cybersecurity-related requirements for certain market intermediaries, the SEC has now adopted them, formally requiring such covered entities to adopt written policies and procedures to prepare for and address cybersecurity incidents. The mandate, adopted on May 15, 2024, principally comes from amendments to Regulation S-P.

Who Is Affected?

Broker-dealers, investment companies, SEC-registered investment advisers and transfer agents, as well as transfer agents registered with other agencies and funding portals under Regulation Crowdfunding.

What Will Be Required?

- Covered entities will be required to have written incident response programs reasonably designed to detect, respond to, and recover from situations in which customer information is improperly accessed or used.
- Entities must develop, maintain, and implement policies and procedures establishing such programs. “Reasonably designed” procedures should specifically include requirements to assess the nature and scope of any cyber breach and to take appropriate steps to contain and control it.
- The programs must provide for timely notification to customers if sensitive customer information was, or is reasonably likely to have been, accessed or used without authorization (as further explained below). Sensitive information is that for which there is a reasonably likely risk of substantial harm or inconvenience to an individual identified with the information.
- The programs must include policies and procedures to address oversight of service providers (including affiliates) through due diligence and monitoring. Policies and procedures must be reasonably designed to ensure that service providers notify the covered institution as soon as possible (no later than 72 hours) after becoming

aware that a breach has occurred (consistent with the Cyber Incident Reporting for Critical Infrastructure Act of 2022). Then the covered institution must initiate its own procedures.

What Customer Notification Is Necessary?

- After becoming aware that an incident is likely to have occurred, as soon as practicable (and, in any event, within 30 days), the covered market participant must notify customers likely to have been affected with details to assist them in responding appropriately.
- The notice must describe, in general terms, the incident and the type of sensitive customer information that was or is reasonably believed to have been accessed or used without authorization.
- The notice must include information such as the date or estimated date of the incident, contact information sufficient to permit an affected individual to contact the covered institution to inquire about the incident, and information about how customers can protect themselves.
- No notice is required if it can be determined that the sensitive customer information has not been, and is not reasonably likely to be, used in a manner that would result in substantial harm or inconvenience. For example, if encryption makes the accessed information unusable to the party exfiltrating the data, no notification would be required.
- A covered entity may delay customer notification for up to 30 days when the SEC receives a request from the U.S. attorney general that notice poses a substantial risk to national security or public safety (under an interagency communication process). The delay is renewable.
- Unlike the original proposal, a customer notice does not have to “[d]escribe what has been done to protect the sensitive customer information from further unauthorized access or use” to avoid providing an updated roadmap to threat actors.
- The notification obligation may be satisfied by ensuring that notice is provided, such as by another institution.

What Significant Other Requirements and Changes Will Go Into Effect?

- Covered institutions must make and maintain written records documenting compliance with the requirements of the amended rules, including the “safeguards rule” and “disposal rule” that address administrative, technical, and physical safeguards for the protection of non-

public customer records and information and proper disposal of such records.

When Does It Bite?

Investment company complexes with net assets of \$1 billion or more; registered investment advisers with assets under management over \$1.5 billion; and broker-dealers and transfer agents (that are not “small entities” under the 1934 Act) will have 18 months after the date of publication in the Federal Register to comply; other covered participants will have 24 months.

This is a more relaxed timetable than the one-year implementation originally proposed, but we encourage covered entities to have their compliance groups prepare or update their policies, and to engage in interpretative discussions with internal and external legal counsel and cybersecurity consultants. Covered institutions should ensure that incident response plans include all requirements and that newly updated policies reflect what will actually happen when response plans get triggered.

Ronald M. Feiman and **Matthew D. Dunn** are partners at Carter Ledyard & Milburn LLP in New York City.

Regulating Artificial Intelligence: Insights From NYDFS' Latest Guidance

By Carly Nixon



Introduction

On Oct. 16, 2024, the New York Department of Financial Services (NYDFS) issued an industry letter (the Letter) offering guidance on assessing cybersecurity risks associated with artificial intelligence (AI) under the existing 23 N.Y.C.R.R. Part 500 framework (Part 500). While the Letter primarily targets institutions covered by Part 500, it also provides valuable insights for all institutions managing the emerging cybersecurity challenges posed by AI.

NYDFS clarifies that the Letter does not introduce new requirements beyond those already outlined in Part 500. Instead, it aims to guide covered institutions in leveraging the Part 500 framework to address AI-related cybersecurity risks and implement appropriate controls. The Letter also encourages institutions to consider the potential benefits of integrating AI into their cybersecurity tools, such as reviewing security logs, analyzing behavior, detecting anomalies, and predicting potential threats. Institutions, whether covered by

Part 500 or not, that significantly rely on AI should review the Letter and evaluate their cybersecurity policies and controls to identify potential enhancements.

This article outlines the background of Part 500, highlights key takeaways from the letter, and provides considerations for covered institutions to manage AI-related cybersecurity risks effectively.

Regulatory Background

On March 1, 2017, NYDFS enacted Part 500, establishing cybersecurity requirements for covered institutions. Since then, the cybersecurity landscape has evolved dramatically. Threat actors have become more sophisticated and prevalent, cyberattacks such as ransomware as a service have become easier to execute, and the cost of remediation has escalated. Simultaneously, more advanced and cost-effective cybersecurity controls have emerged to help manage cyber risks.

NYDFS has learned through investigating hundreds of cybersecurity incidents that institutions can significantly improve their defenses. In response to these developments, Part 500 was amended, with the updated requirements taking effect on Nov. 1, 2023.

Among the key requirements in the Nov. 1, 2023, update is the requirement to perform risk assessments at least once a year, or whenever a change in the business or technology causes a material change to the covered entity's cyber risk. The amended definition of "risk assessment" expanded the scope to include:

[t]he process of identifying, estimating, and prioritizing cybersecurity risks to organizational operations (including mission, functions, image, and reputation), organizational assets, individuals, customers, consumers, other organizations and critical infrastructure resulting from the operation of an information system. Risk assessments incorporate threat and vulnerability analyses and consider mitigations provided by security controls planned or in place.

Additional notable requirements also include enhanced reporting requirements for chief information security officers, new responsibilities for senior governing bodies, mandatory encryption of all nonpublic information in transit, and updated incident response and disaster recovery plans.

NYDFS routinely issues guidance regarding Part 500, and in its response to several inquiries about how AI affects Part 500 requirements, the NYDFS produced the Letter. The Letter is meant "to explain how covered entities should use the framework set forth in Part 500 to assess and address cybersecurity risks arising from AI."

Cybersecurity Risks Associated With AI

The Letter presents two primary ways that threat actors have leveraged AI to increase the efficacy of cybersecurity attacks:

- **AI-Enabled Social Engineering.** This category covers increasingly sophisticated deepfakes that are being used effectively in social engineering attacks, including realistic and interactive audio, video, and text-based messages that target specific individuals via email (phishing), telephone (vishing), text (smishing), videoconferencing, and online postings. These attacks are designed to trick unsuspecting employees into sharing sensitive information or access credentials or transferring funds to accounts controlled by the attackers.

- **AI-Enhanced Cybersecurity Attacks.** AI allows threat actors to amplify the potency, scale, and speed of existing types of cyberattacks and to quickly identify and exploit security vulnerabilities. AI can also accelerate the development of new malware and change existing ransomware so it can bypass defensive security controls. It also lowers the barrier to entry for new attackers, who can use AI to quickly learn how to launch successful attacks.

The Letter also notes two risks caused by a covered entity's use of AI:

- **Exposure of Theft of Vast Amounts of Nonpublic Information.** Use of AI by companies will often involve the collection and processing of large volumes of nonpublic information, providing more opportunities for attacks and creating more data, devices, and locations for companies to protect. Additionally, the data used in AI applications sometimes is biometric data, such as faceprints or fingerprints, which a threat actor can leverage to bypass multifactor authentication (MFA) and gain access to key information systems.
- **Increased Vulnerabilities Due to Third-Party, Vendor, and Other Supply Chain Dependencies.** Cyber-related AI risks are further compounded by companies' heavy reliance on third-party service providers, which are vulnerable to cybersecurity attacks, to provide them with AI tools and/or the data used to train and operate them. NYDFS cautions that "each link in this supply chain introduces potential security vulnerabilities" that threat actors aim to exploit.

Controls and Measures for Mitigating Cybersecurity Risks of AI

The NYDFS guidance underscores the criticality of proactive risk management and comprehensive security controls to address these AI-driven challenges. By integrating these considerations into their cybersecurity frameworks, institutions can better safeguard against evolving threats while harnessing the potential benefits of AI. NYDFS proposes the following six ways to mitigate AI risks:

1. AI-Specific Risk Assessments and Preparedness

The Letter emphasizes the value of incorporating AI-specific factors into a covered entity's risk assessments. It encourages institutions to evaluate AI-related risks across their ecosystems, including third-party vendors. When new AI risks are identified, institutions should determine if their cybersecurity policies and procedures require updates to address these risks. The Letter also outlines the expectation that institutions be prepared for potential cybersecurity incidents stemming from AI use, regularly test this preparedness, and

ensure that personnel – particularly senior leadership and boards of directors – are well informed about AI-related risks.

2. Vendor and Third-Party Management

NYDFS strongly advises covered institutions to include AI-related risks in their due diligence processes for third-party vendors. Institutions must ensure these vendors adhere to minimum cybersecurity standards and notify them promptly of cybersecurity incidents, as required under existing Part 500 rules. NYDFS also recommends seeking additional assurances, such as warranties and representations, regarding the secure use of sensitive information provided to third parties.

3. Enhanced Access Controls

To counter AI-driven threats, the Letter urges covered institutions to implement strong access controls, including MFA, which will become mandatory for all internal system access by November 2025. The NYDFS cautions the reliance on MFA methods vulnerable to AI deepfakes, such as SMS, voice, or video verification. Instead, it recommends alternatives like digital certificates or physical security keys. For biometric authentication, institutions are advised to adopt advanced techniques like liveness detection or texture analysis to verify that inputs come from live individuals. Institutions are also reminded to comply with Part 500's requirements to limit privileged access strictly to job-related needs, reduce the number of privileged users, and revoke access promptly when it no longer is required.

4. Cybersecurity Training

The Letter emphasizes the importance of customizing cybersecurity training programs to specifically address AI-related risks, as mandated annually under Part 500. It provides recommendations for tailoring training content to various roles in an organization.

For all employees, the training should focus on understanding the risks associated with AI and the strategies implemented by the organization to mitigate them. Employees should also learn to recognize and respond to AI-enhanced social engineering attacks; verify unexpected requests for credentials, fund transfers, or sensitive information; and identify scenarios requiring human oversight for verification.

For cybersecurity teams, the training should delve deeper into how threat actors exploit AI for social engineering and to amplify cyberattacks. Additionally, these teams should be equipped with knowledge of how to harness AI to strengthen cybersecurity defenses.

For employees responsible for managing AI systems, the training should emphasize securing AI systems against cyber threats, designing and developing AI tools with robust se-

curity measures, and crafting secure queries to prevent the unintentional disclosure of sensitive information.

5. Monitoring

Institutions utilizing AI-enabled products or services are advised to monitor these systems for unusual queries that could indicate attempts to extract sensitive data. Additionally, institutions should consider blocking employee queries that could inadvertently expose nonpublic information to public AI systems.

6. Data Management and Minimization

The Letter draws attention to the value of implementing data minimization practices as outlined in Part 500. Institutions should routinely dispose of nonpublic information that is no longer needed for legitimate business purposes. Covered institutions are reminded of their obligation (effective November 2025) to maintain detailed data inventories, and they are encouraged to assess information systems reliant on AI to prioritize data protection efforts.

Practical Considerations and Key Insights

NYDFS continues to lead cybersecurity regulation in the financial sector. While the Letter does not introduce new requirements, it signals a potential for future amendments to Part 500 to address AI-related risks explicitly.

All institutions – not just financial ones – should evaluate AI-related risks, whether posed by malicious actors leveraging AI or by their own use of AI tools. Covered institutions should review and refine their existing cybersecurity policies to address AI-specific vulnerabilities effectively. Integrating general cybersecurity and AI risk management programs will ensure comprehensive oversight and prevent AI-related risks from being overlooked.

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Restoring Trust: The Role of the Cryptocurrency Accountability Act in Government Transparency

By Julia Vavrinec

The issues facing cryptocurrency regulation are legion. The election of a new administration has accompanied exuberance among crypto advocates. Bitcoins are trading – as of this writing – at around \$100,000.

This article focuses on the regulation of crypto assets held by elected officials. The challenges facing regulators with respect to crypto assets are important to understand. The nature of crypto as both a currency and a security make it particularly challenging from a disclosure and transparency standpoint.

I. Introduction

A. What Is Cryptocurrency and How Does It Work?

Cryptocurrency, or “crypto,” is a digital currency used as an alternative payment method and derives its name from the cryptographic techniques that enable crypto holders to trade and spend money without relying on centralized banks or governments.¹ In essence, cryptocurrency is a “digital, encrypted, and decentralized medium of exchange.”² As of 2023, there are more than 1.8 million different cryptocurrencies in existence.³ These digital assets are underpinned by blockchains, which maintain an immutable transaction ledger and record ownership, preventing unauthorized duplication.⁴ Individual units of crypto are known as “coins” or “tokens,” each serving various purposes, such as facilitating transactions, acting as stores of value, or enabling participation in specific software programs.⁵

Blockchains serve as digital transaction ledgers upheld by a network of computers, establishing an exceedingly robust defense mechanism against hacking attempts, empowering individuals to conduct cryptocurrency exchanges independently, eliminating the need for intermediaries such as centralized banks.⁶ Conceptually, a blockchain resembles a shared, virtual checkbook distributed across numerous computers, with each participant using the cryptocurrency as their personal checkbook to contribute to a unified transaction.⁷ These transactions, grouped into lists known as blocks, are securely interlinked through cryptographic methods and verification of each transaction is autonomously conducted by peer-to-peer computer networks.⁸

Two prevailing validation techniques in blockchain technology are “proof of work” and “proof of stake.”⁹ In the case of proof of work, miners tackle intricate mathematical puzzles,

certifying a cluster of transactions and appending them to the blockchain ledger.¹⁰ On the other hand, proof of stake seeks to reduce the energy and computational resources necessary to check transactions by limiting the number of transactions each miner can verify based on the amount they are willing to “stake” or temporarily lock up.¹¹ In this approach, those who stake cryptocurrency become eligible to validate transactions, and the probability of being chosen increases with the size of the stake.¹²

Blockchains promote decentralization, transparency, anonymity, accuracy, and security.¹³ In the case of bitcoin, which adopts a “proof of work” approach, the blockchain operates as follows: the purchase and sale of bitcoin are initially entered and transmitted to a global network of powerful computers, known as nodes, which engage in competitive confirmation processes through computer algorithms, or “mining.”¹⁴ The miner who successfully completes a new block is rewarded with bitcoin, with these rewards being a combination of freshly minted bitcoin and network fees, passed on to the buyer and seller.¹⁵ Following cryptographic confirmation of the purchase, the sale details are incorporated into a block within the distributed ledger, which is then confirmed by the majority of the network participants.¹⁶ This block is permanently linked to all preceding blocks of bitcoin transactions, facilitated by a cryptographic fingerprint, referred to as a “hash,” solidifying the processing of the sale.¹⁷

Cryptocurrency usage has faced significant criticism due to its substantial environmental impact.¹⁸ Mining, integral to the functioning of cryptocurrencies, consumes a staggering amount of energy – surpassing the annual energy consumption of some countries.¹⁹ To put this into perspective, bitcoin mining alone is responsible for approximately 68.8 million metric tons of carbon dioxide emissions per year.²⁰ One bitcoin transaction’s carbon footprint is equivalent to 762,000 Visa transactions.²¹

B. Differences Between Cryptocurrency and Traditional Investment Vehicles

Cryptocurrency can be likened to traditional investment vehicles such as stocks and bonds, sharing commonalities in terms of inherent risk, market volatility, online trading platforms, the presence of potential scammers, lack of actual value of the asset, and participation from everyday investors.²² However, several fundamental distinctions set them apart.

Notably, the key differentiation lies within the supply and regulatory aspects.²³ Stocks typically exhibit less variability in supply, as the number of shares is under the control and support of the issuing company's operations.²⁴ Furthermore, the stock market significantly outpaces the crypto market in size, with the total crypto market capitalization representing a mere 2.5% of the stock market's vast scope.²⁵ Stocks are subject to meticulous oversight by securities and other regulatory bodies, which serve as protective measures for shareholders, while cryptocurrencies are often rooted in the principles of decentralization and anonymity, which can result in fewer safeguards for crypto holders.²⁶ Finally, when a stockholder acquires shares, they essentially become a part owner of the controlling company, while a crypto holder possesses a digital currency with distinct characteristics unsupported, presumably, by company earnings.²⁷

C. History of Cryptocurrency

The origins of cryptocurrency can be traced back to David Chaum of U.C. Berkeley, who laid the foundation for future blockchain advancements with his publication *Computer Systems Established, Maintained, and Trusted by Mutually Suspicious Groups*.²⁸ Chaum's groundbreaking contribution was the creation of the "blinding formula," a pioneering innovation that allowed secure peer-to-peer transactions of digital tokens without the need for centralized control.²⁹ Subsequently, he went on to develop a digital currency known as "eCash."³⁰ Although eCash eventually faced funding challenges and waned in the 21st century, it served as a catalyst for further innovations in digital currency.³¹ Notable attempts, such as eGold and Bit Gold, aimed to replicate the stability of gold's value, met limited success.³² However, the pursuit of a goldlike digital currency did not deter the enigmatic Satoshi Nakamoto, who proceeded to create bitcoin, a cryptocurrency designed to emulate the enduring qualities of gold, marking a pivotal turning point in the evolution of digital currencies.³³

In 2008, Nakamoto unveiled the groundbreaking white paper titled "Bitcoin: A Peer-to-Peer Electronic Cash System," outlining a visionary plan for a peer-to-peer electronic currency.³⁴ This pivotal document addressed the issues of central bank control and government dominance over citizens' financial resources, introducing the concept of a virtual coin as a solution.³⁵ Bitcoin's core mission was to eliminate the "control, oversight and fees associated with cash transactions."³⁶

Nakamoto's innovative design called for a limited supply of 21 million bitcoins and introduced the consensus mechanism known as "proof of work" to validate transactions on the bitcoin network.³⁷ This system compelled computers to solve algorithmic puzzles to record new transactions on a public ledger called the "blockchain," which serves as a transparent repository of all network transactions.³⁸ Miners, who delegate computing power to the bitcoin network, are rewarded with

bitcoin for each block they verify, which undergoes periodic halving every four years until the total 21 million supply is exhausted.³⁹

In early 2009, Nakamoto mined the very first bitcoin block, often referred to as the "genesis block," and conducted the initial bitcoin transaction with developer Hal Finney.⁴⁰ A year later, a historic milestone was achieved when a programmer traded 10,000 bitcoin for a sum of \$25 worth of pizza, thus establishing the first tangible value of a bitcoin, equating to four bitcoins per penny.⁴¹

Bitcoin largely flew under the radar until 2011, when it garnered significant media attention, particularly through *Forbes'* coverage, propelling its value to \$9 and marking a notable shift from its earlier \$1 per coin exchange rate.⁴² The mainstream spotlight on bitcoin triggered the proliferation of "altcoins," giving rise to digital currencies like Litecoin and XRP.⁴³ By 2014, bitcoin had breached the triple digit price range.⁴⁴ However, a significant setback occurred when the bitcoin exchange, Mt. Gox, experienced a major security breach, resulting in the theft of 850,000 BTC (bitcoin tokens) by hackers.⁴⁵ This incident severely shook faith in cryptocurrency, prompting the emergence of secure centralized crypto exchanges (CEXs) that offered insurance protections and enhanced safety measures.⁴⁶ These practices are now widely adopted by major cryptocurrency exchanges.⁴⁷ In 2013, bitcoin reached a milestone by attaining a price of \$1,000, only to subsequently experience a crash to \$300 – it would take two years to reach \$1,000 again.⁴⁸

In 2015, ethereum emerged as the inaugural major non-bitcoin cryptocurrency project with ambitions extending beyond establishing its peer-to-peer payment system.⁴⁹ The pioneers of ethereum aimed to revolutionize the internet by introducing groundbreaking concepts such as automated smart contracts, which could execute commands solely through code once predefined conditions were met, as well as nonfungible tokens (NFTs) and decentralized finance ("DeFi").⁵⁰ Ethereum's advent also catalyzed the rise of initial coin offerings (ICOs), innovative fundraising platforms that permitted investors to trade shares in startup ventures using a process similar to cryptocurrency trading.⁵¹ However, ethereum encountered a challenge akin to bitcoin when it suffered a security breach resulting in the theft of \$60 million from a decentralized autonomous organization (DAO) designed as an investment vehicle.⁵² To address this breach and restore trust in the blockchain, the ethereum community initiated a "fork," creating a new ethereum that effectively resolved the issue and reinforced confidence in the platform.⁵³

Commencing in 2017, bitcoin's price rose significantly, where it briefly hit \$20,000 per coin.⁵⁴ NFTs started to emerge as unique digital collectibles, along with the burgeoning growth of DeFi projects operating on the ethereum

blockchain.⁵⁵ In 2020, bitcoin made an astonishing leap, nearly reaching a staggering \$70,000.⁵⁶ Yet, the year 2022 delivered a severe setback to the crypto sphere when TerraForm Labs' U.S. dollar "stablecoin" plummeted to zero in value, impacting all affiliated companies and casting a shadow over the broader cryptocurrency market.⁵⁷ Remarkably, the crypto market retained its \$1 trillion market cap in 2022.⁵⁸ Since bitcoin's inception, a staggering number of over 21,000 different cryptocurrencies have been created.⁵⁹ As of August 2023, the cumulative value of existing cryptocurrency is around \$1.05 trillion, with bitcoin accounting for around \$508 billion of this total.⁶⁰

Presently, U.S. residents are obliged to include cryptocurrency sales in their tax returns, following the Internal Revenue Service's 2014 directive categorizing cryptocurrency as property for federal income tax purposes, necessitating comprehensive disclosures of crypto transactions.⁶¹ With the surging popularity of cryptocurrencies, government involvement has surged in tandem. On March 9, 2022, President Joe Biden issued an executive order initiating a wideranging review of digital assets, and granted federal agencies the authority to scrutinize digital currencies and evaluate their potential impact on the overall financial stability.⁶²

Notably, a growing number of major companies, including AT&T, Microsoft, Overstock.com, Twitch, and AMC Theaters, have embraced cryptocurrency as a means of payment for consumer purchases.⁶³ Furthermore, some nations, such as El Salvador and the Central African Republic, have officially recognized cryptocurrency as legal tender, although the implementation has encountered certain challenges.⁶⁴

D. Current Required Disclosures for Congressmembers

One significant area of crypto regulation is disclosure of crypto assets by elected officials. The Ethics in Government Act of 1978 (EIGA) marked a pivotal moment in government ethics, giving birth to the Office of Government Ethics (OGE), with the goal of standardizing and harmonizing ethics policies across the executive branch while instituting a comprehensive financial disclosure framework for officials in high-risk conflict of interest positions.⁶⁵ This landmark legislation introduced the practice of annual financial disclosure for senior federal personnel, including members of Congress and congressional candidates.⁶⁶

Subsequently, the Ethics Reform Act of 1989 streamlined and consolidated these requirements into a single, unified title application to the entire federal government.⁶⁷ This alteration necessitates that financial disclosure statements detail external compensation, holdings, and business transactions from the preceding calendar year.⁶⁸ Furthermore, the Stop Trading on Congressional Knowledge Act ("STOCK Act")

requires Congress to establish and maintain an electronic filing system for financial disclosure reports.⁶⁹ It is important to note that despite each branch having its own unique financial disclosure website and procedures, these standards remain consistent throughout Congress and the executive branch.

For the Senate, the Ethics in Government Act of 1978, Senate Rule 34, and Senate Rule 41 collectively mandate that senators, officers, certain employees, and candidates fulfill the obligation of publicly filing financial disclosure with the Office of Public Records, overseen by the secretary of state.⁷⁰ Conversely, in the House of Representatives, the Committee on Ethics develops the forms and instructions for financial disclosure and rigorously scrutinizes the completed statements of House members, officers, employees, candidates, and certain other legislative branch personnel to ensure their compliance with applicable laws.⁷¹

As it stands, financial disclosure statements encompass the comprehensive disclosure of outside compensation, financial holdings, and business transactions for all eligible individuals.⁷² An "employee" is any individual (excluding Congress members) whose salary is at or above the filing threshold.⁷³ This threshold is established at 120% of the basic rate of pay in effect for GS15⁷⁴ of the General Schedule, or \$141,022 for the year 2023.⁷⁵

A "candidate" is defined as an individual who either: (1) seeks nomination for election to federal office and has received contributions aggregating in excess of \$5,000; or (2) has made expenditures aggregating in excess of \$5,000, or has given consent to another to receive contributions or make expenditures on their behalf aggregating in excess of \$5,000.⁷⁶ In the exceptional scenario where a member lacks an employee on their personal staff receiving compensation at the senior staff rate, they must designate a principal assistant to file, who will typically be an employee whose role allows them to act on behalf of the member with the requisite authority.⁷⁷

Income is divided into two categories: earned and unearned income.⁷⁸ Earned income encompasses compensation derived from employment or personal efforts and must be disclosed when it totals \$200 or more from any one source in a calendar year.⁷⁹ Additionally, if a filer's spouse's earned income exceeds \$1,000, it must also be reported.⁸⁰ Earned income by a dependent child is not subject to reporting requirements.⁸¹

On the other hand, unearned income comprises income generated from property held for investment purposes or income production, including assets like real estate, stocks, and retirement accounts.⁸² Any asset held for investment purposes must be disclosed if its value exceeds \$1,000 at the end of the calendar year, or if it generates more than \$200 in income during the year.⁸³ Furthermore, it is essential to

specify the identity and category of the asset's value.⁸⁴ When stocks are valued at over \$1,000 in different companies, each company must be listed separately.⁸⁵

In the case of holdings and income from a trust or other financial arrangement in which the reporting individual, spouse, or dependent child holds a beneficial interest in principal or income, disclosure is mandatory.⁸⁶ There are exceptions when these assets are held in a qualified blind trust, a qualified diversified trust, or a trust not created by the beneficiary and for which neither the reporting individual, spouse, nor dependent child possesses specific knowledge about the holdings or sources of income.⁸⁷

The financial disclosure statement requires a brief description, the date, and value category for any real property, stocks, bonds, commodities, futures, or other securities transactions exceeding \$1,000.⁸⁸ Furthermore, personal obligations exceeding \$10,000 owed to a single creditor must be detailed.⁸⁹ The statement mandates reporting gifts valued above a minimum threshold (which stands at \$415 in 2023).⁹⁰ However, it is important to note that gifts from relatives, personal hospitality, and local meals are exempt from this disclosure requirement.⁹¹ Moreover, any travel-related expenses provided by nongovernmental sources that exceed \$390 from a single source must be disclosed.⁹² Additionally, the statement must include information about agreements related to future employment, leaves of absence during government service, continuation of payments from a private source, deferred compensation plans, or continued participation in an employee benefit or welfare plan of a former employer.⁹³ Lastly, individuals who were members or partners of a firm or association that provided services must disclose the clients or customers for whom they directly provided services to.⁹⁴

1. Executive Branch Officials Must Disclose Cryptocurrency Holdings

In a legal advisory letter, the OGE declared cryptocurrency as “property held . . . for investment or the production of income” for purposes of public and confidential financial disclosure, rather than legal tender or “real” currency.⁹⁵ Based on this finding, OGE found that executive branch employees are therefore required to report their holdings on their public or confidential financial disclosure report subject to applicable reporting thresholds.⁹⁶ The OGE based its decision on several factors, including the fact the Internal Revenue Service (IRS) treats virtual currency as property for U.S. federal tax purposes, the Commodity Futures Trading Commission (CFTC) views certain virtual currency as a commodity, and officials at both the CFTC and Securities and Exchange Commission (SEC) noted that virtual currencies are often promoted as investment assets.⁹⁷

Furthermore, the EIGA requires employees to report any interest in property held for either investment purposes or income purposes. Therefore, as OGE has deemed crypto holdings as property held for investment or income purposes, this interest must be reported if it meets the income or value reporting thresholds.⁹⁸ As cryptocurrency has been deemed an investment asset, it may create a conflict of interest for employees who own it.⁹⁹ In order to prevent such a conflict from occurring, agency ethics officials should analyze whether their employees' official duties would have an effect on the value of their virtual currency, similar to how they would with property held for investment or the production of income.¹⁰⁰

2. American Taxpayers Are Required To Disclose Crypto

In addition to disclosure of crypto assets by elected officials, the Internal Revenue Service (IRS) requires U.S. taxpayers to disclose their digital asset related income.¹⁰¹ The IRS asks taxpayers if they have received or sold, exchanged, or disposed of a digital asset at any time during the previous calendar year.¹⁰² The IRS classifies a digital asset as a digital representation of value that is recorded on a cryptographically secured, distributed ledger, or any similar technology, such as, convertible virtual currency and cryptocurrency, stablecoins, and NFTs.¹⁰³ Therefore, a taxpayer must check “yes,” and disclose their holdings if they: received digital assets as payment for property or services; received digital assets resulting from a reward or award; received new digital assets resulting from mining, staking, and similar activities; received digital assets resulting from a hard fork (a branching of a crypto's blockchain that splits a single crypto into two); disposed of digital assets in exchange for property/services; disposed of a digital asset in exchange or trade for another digital asset; sold a digital asset; or otherwise disposed of any other financial interest in a digital asset.¹⁰⁴ The only exceptions to this are if one simply held their assets in an account, transferred assets between accounts, or purchased digital assets using real currency.¹⁰⁵

In essence, the IRS mandates that any U.S. taxpayer with even a nominal amount of cryptocurrency must disclose it on their tax returns for the relevant year. This requirement stems from the IRS's classification of cryptocurrency as property, subject to potential capital gains or losses based on market fluctuations.¹⁰⁶ The IRS acknowledges that individuals may hold crypto for investment objectives, and much like stocks, bonds, and other investment assets, taxpayers may experience capital gains or losses upon selling or exchanging crypto.¹⁰⁷

II. Analysis

A. Proposed Legislation and How It Amends Current Disclosure Laws

In Section 2 of the Cryptocurrency Accountability Act (the “bill”), it states that the bill will amend Section 13104 of Title 5 of the United States Code to incorporate a require-



ment that any report filed by a Member of Congress under Section 13104 must include: “(a) brief description, the date, and category of any purchase, sale, or exchange in cryptocurrency by the Member or spouse or dependent child of the member during the preceding calendar year which exceeds \$1,000; and (b) the identity and category of value . . . of any interest in cryptocurrency held during the preceding calendar year by the Member or spouse or dependent child of the Member.”¹⁰⁸

This bill was introduced by Representative Elissa Slotkin, United States House Representative from the Seventh District of Michigan.¹⁰⁹ Representative Slotkin introduced this legislation, as the Agriculture Committee she also sits on considers legislation to regulate cryptocurrency exchanges,¹¹⁰ in order to establish a regulatory framework that shields consumers and investors by establishing consumer protections and rules for market participants.¹¹¹ The main goal of this legislation is to “ensure that members of the body tasked with oversight of crypto also have to publicly disclose their investments.”¹¹²

Overall, the bill would: (1) require disclosure of any cryptocurrency holdings or transactions by members, their spouses, or their dependents above \$1,000; (2) strengthen the punitive measures for late disclosures of cryptocurrency holdings or transactions from \$200 to \$500, or 5% of the asset that was disclosed late (whichever is greater); and (3) strengthen the punitive measures for intentionally falsifying disclosures of cryptocurrency holdings or transactions, in line with existing criminal punishments related to falsifying disclosures, to \$66,000 or 5% of the asset that was falsified, whichever is greater.¹¹³ In sum, the bill amends the EIGA, which requires members of Congress and employees of the legislative branch to disclose sources of income in order to prevent corruption.

Under 5 U.S.C. Section 13106 (titled “Failure to file or filing false reports”), any individual who files a report required to be more than 30 days after the due date initially required, shall pay a filing fee of \$200.¹¹⁴ Furthermore, in the case of falsified reports, the attorney general may bring a civil action in district court, and the civil penalty shall not exceed \$50,000.¹¹⁵ Aside from adding cryptocurrency as one of the required asset disclosures, the bill seems to aim at strengthening punitive measures relating to cryptocurrency as a whole – setting a new stage for regulation and punitive measures regarding cryptocurrency disclosures.

B. Analysis of Section 13104

5 U.S. Code Section 13104 is titled, “Contents of reports,” and details what should be included in a report filed pursuant to Sections 13103(d) and (e).¹¹⁶ Section 13101(d) describes that “any individual who is an officer or employee described in subsection (f) during any calendar year and performs the duties of the position or office for a period in excess of [sixty] days in that calendar year shall file . . . a report containing the information described in section 13104(a) of this title.”¹¹⁷

Subsection (f) details who is required to file such a report, including: the president; the vice president; each officer or employee in the executive branch who occupies a position classified above GS15 of the General Schedule or for which the rate of basic pay is equal to or greater than 120% of the minimum rate of basic pay payable for GS15;¹¹⁸ administrative law judges; executive employees not mentioned previously who are excepted from the competitive service by reason of being a confidential or policy making character; the postmaster general; the deputy postmaster general; each governor of the Board of Governors of the United States Postal Service; and each employee or officer who occupies a position for which the basic rate of pay is equal to or greater than 120% of the minimum rate of basic pay payable for GS15 of the General Schedule.¹¹⁹

Section 13104 consists of several components required in an annual report, including: income (such as dividends, rents, interest, and capital gains) over \$200; gifts and reimbursements over \$250 or more than the minimum value established by Section 7342(a)(5), whichever is greater; interests in property exceeding \$1,000; liabilities that exceed \$10,000 (except mortgages and loans that do not exceed the purchase price of the item which secures it); transactions exceeding \$1,000 in real property or in stocks, bonds, commodities futures, and other forms of securities; positions with outside entities and major sources of compensation; agreements or arrangements relating to other employment; and qualified blind trusts. Notably, Section 13104 already requires the disclosure of income aggregating \$200 or more in value, interests in property which exceeds \$1,000, and transactions

in real property, stocks, bonds, and other forms of securities which exceed \$1,000.¹²⁰

C. Ramifications and Consequences of Proposed Legislation

As of now, no nation besides South Korea mandates that elected officials reveal their cryptocurrency holdings. As of 2024, South Korean high-ranking public figures are required to disclose their crypto assets, and this information will be accessible through the government's "Public Ethics and Transparency Initiative" platform, dedicated to scrutinizing the property disclosures of public officials.¹²¹ This move aims to bolster transparency by introducing an "integrated public disclosure service" that includes the registration of virtual assets.¹²² The decision to implement these measures was prompted by the revelation that a public official possessed at least \$4.5 million worth of WEMIX tokens, developed by the South Korean blockchain gaming company Wemade.¹²³ This discovery raised significant concerns regarding potential conflicts of interest and eroded public confidence in the government.¹²⁴

D. Reactions and Impacts of the Ethics in Government Act of 1978

The EIGA was enacted with the aim to "restore the public's confidence in governmental integrity that was lost as a result of the Watergate scandal."¹²⁵ Presently, public trust in government has plummeted to historic lows, with only 16% of respondents stating that they trust the government to consistently do what is right.¹²⁶ In comparison, public trust in the government fluctuated between 32% and 27% from the time of the Watergate scandal to the implementation of the EIGA.¹²⁷

However, confidence in the EIGA was not always unwavering. Upon its enactment, there were concerns about a potential mass resignation of government officials, as many were reluctant to disclose their finances.¹²⁸ Commentators feared that finding competent replacements for departing officials would be challenged due to the Act's "increasingly burdensome duties and constraints" imposed by the Act.¹²⁹ Skepticism surrounded its implementation, with one individual declining a nomination for a high-level executive branch position to shield his financial holdings from his children.¹³⁰ The White House counsel to President Reagan echoed concerns from prospective appointees, worried about disclosing their spouses' names and the potential risk to their children becoming "targets for kidnappers."¹³¹

Despite these apprehensions, Bob Flynn, then acting chief of agency relations for the OGE, dispelled these concerns and reassured that financial disclosure could help mitigate the "collateral issue syndrome," where high-level government officials become targets for opponents seeking evidence of con-

flicts of interest.¹³² By voluntarily disclosing their financial interests and having them reviewed by an ethics officer or the OGE, conflicts of interest could be identified and addressed proactively.¹³³

Moreover, the concerns raised were largely unfounded, as the Act explicitly prohibited the misuse of any disclosure report for illicit purposes.¹³⁴ Furthermore, the Act empowered the U.S. attorney general to initiate civil actions and impose penalties on individuals exploiting such reports for prohibited purposes, thereby establishing a robust deterrent against abuse of disclosure requirements.¹³⁵ One notable instance of opposition to the Act was exemplified in the case of *Duplantier v. United States*.¹³⁶ In this case, Duplantier initiated a class action suit contesting the constitutionality of the provision within the EIGA mandating public financial disclosure by federal judges.¹³⁷ Duplantier's argument centered on challenging the constitutionality of the Act, alleging:

- (1) that the Act is contrary to the doctrine of separation of powers because it intrudes on the independent decisional freedom of United States judges;
- (2) that the imposition of civil penalties on judges who fail to file is a violation of the Article III prohibition against diminution of a judge's compensation during his tenure;
- (3) that the Act violates the Due Process and Equal Protection clauses of the Fifth Amendment both by reason of being irrational and arbitrary, and by placing stricter duties on judges, who are required to meet disclosure statements with two different offices, than on other [F]ederal officials regulated by the Act;
- (4) that the Act, in requiring disclosure at all, impermissibly intrudes into the sphere of family life.¹³⁸

The court ultimately rejected these arguments and held that the "overriding need to promote public confidence in government and deter conflicts of interest gave Congress the power to legislate in furtherance of that need, when only a slight interference with the autonomy of the judiciary resulted."¹³⁹

Before the Act's implementation, White House employees earning an annual salary at the GS13 level or above were required to submit financial information to the Office of Counsel to the President.¹⁴⁰ Therefore, when the Act was proposed in 1977, it represented progress from previous efforts to enhance public confidence in the federal government by mandating disclosure of financial interests by government officials and high-level employees.¹⁴¹ The pre-ethics Act practice for financial disclosure had demonstrated various inadequacies, including inconsistent disclosure requirements

across agencies and branches within the federal system.¹⁴² Moreover, procedures for collecting, reviewing, and managing disclosure statements were largely left to individual agencies, resulting in ineffectiveness.¹⁴³ Hence, the Act aimed to standardize the disclosure system, eliminating discrepancies, and bolster enforcement through the OGE.¹⁴⁴

III. Reasoning

The reasons why the Ethics in Government Act of 1978 was passed draws a stark comparison to the state of disclosure laws today. The passage of the Cryptocurrency Accountability Act represents a crucial step toward enhancing transparency, accountability, and ethical conduct among government officials in the digital age. By aligning with existing executive branch disclosure laws and by addressing emerging financial technologies, Congress has an opportunity to uphold the principles of good governance and reinforce public trust in democratic institutions.

As highlighted above, one pressing reason for the passing of the Ethics in Government Act of 1978 was the need to rectify discrepancies across branches. This notion of rectifying discrepancies can be extended to the current scenario of nonmandatory disclosure of cryptocurrency assets. As previously noted, the OGE has determined that executive branch employees must disclose their crypto holdings on their financial reports, considering cryptocurrencies as property for investment or income purposes.¹⁴⁵ Hence, if the OGE, which oversees financial disclosure regulations across government branches, mandates executive branch employees to reveal these assets, what rationale exists for not extending this requirement to the judicial and legislative branches?

The definition of property or income remains consistent across agencies. For example, any income (including dividends and capital gains) over \$200 or transactions in property or securities over \$1,000 must be reported, irrespective of the branch.¹⁴⁶ As affirmed by the OGE, crypto assets are already classified as property.¹⁴⁷ Additionally, as the IRS has denoted crypto as property that is subject to capital gains and losses, it is only logical to extend disclosure requirements to crypto, as current disclosure laws require income (including dividends, rents, interest, and capital gains) over \$200, interests in property exceeding \$1,000, transactions exceeding \$1,000 in real property or in stocks, bonds, commodities futures, and other forms of securities to be reported.¹⁴⁸ To avoid disparities among branches, it is only logical for the OGE to categorize cryptocurrency assets as property for investment or income purposes and consequently incorporate them into financial disclosure obligations.

Moreover, echoing the aftermath of the Watergate scandal, the American populace found itself grappling with a pervasive lack of confidence in governmental institutions.¹⁴⁹

This sentiment underscores the urgent need for initiatives akin to the Ethics in Government Act to mend the fractured relationship between citizens and their governing bodies.

In tandem with this crisis of trust, the burgeoning realm of cryptocurrency presents yet another facet of skepticism.¹⁵⁰ A staggering 75% of U.S. residents familiar with cryptocurrency express reservations regarding its reliability and safety – a testament to the prevailing distrust permeating modern society.¹⁵¹

In late July 2023, a pivotal moment unfolded in U.S. politics as Senators Kirsten Gillibrand and Josh Hawley jointly introduced the Ban Stock Trading for Government Officials Act.¹⁵² This legislation aimed to erect a formidable barrier against potential conflicts of interest by prohibiting government officials from owning or engaging in stock trading activities.¹⁵³

This monumental proposal resonated deeply with the American public, capturing the attention and support of nearly 86% percent of the populace.¹⁵⁴ The widespread backing for such a ban underscored a growing sentiment across the nation, reflecting a profound desire for transparency, accountability, and ethical governance within the corridors of power. The genesis of this bill stemmed from a series of previous attempts to address the perceived ethical lapses within government ranks regarding stock ownership and trading. Despite prior setbacks, the momentum behind this latest initiative signaled a resolute determination to enact substantive reform.

In the wake of failed legislative efforts in 2023, the urgency for action only intensified. Another related bill emerged advocating for the imposition of stringent measures requiring all members of Congress and their immediate spouses to either place their stock holdings in blind trusts or divest entirely. This multifaceted approach underscored a comprehensive commitment to restoring public trust and integrity in governance.¹⁵⁵ Moreover, as the landscape of financial markets evolves, so too do the concerns of the American populace. With the meteoric rise of cryptocurrency's prominence, it has become increasingly apparent that the specter of conflicts of interest extends beyond traditional stock holdings. The need for vigilant oversight and regulation in the realm of cryptocurrency holdings among government officials becomes ever more pressing, mirroring the concerns that initially propelled the discourse surrounding stock trading.

Compounding these concerns, recent revelations regarding the involvement of 21 members of Congress or their immediate family in approximately \$1.8 million worth of cryptorelated investments further erode public confidence.¹⁵⁶ As underscored by *U.S. News & World Report*, the onus falls on leaders to uphold transparency and reliability if they seek

to regain the trust of their constituents.¹⁵⁷ To bolster a climate of trust and public support, stringent measures must be implemented. Chief among these is the unequivocal disclosure of all property and investment holdings, thereby ensuring transparency and enabling Americans to identify potential conflicts of interest. These transparent disclosure laws are imperative, serving as a cornerstone in rebuilding faith in governmental integrity.

The OGE has issued a stern warning, highlighting the potential conflicts of interest that may arise from federal employees owning cryptocurrency¹⁵⁸ – a cautionary tale reminiscent of the EIGA, which aimed to mitigate conflicts of interest stemming from investment holdings among government officials.¹⁵⁹

Furthermore, the OGE has mandated stringent measures, stipulating that employees with any cryptocurrency holdings are prohibited from involvement in formulating crypto regulations or policies if such matters could directly impact the value of their digital assets.¹⁶⁰ This mirrors the protocol applied when government employees are tasked with matters involving companies in which they hold stock interests.¹⁶¹

Enforcing the disclosure of crypto holdings not only bolsters transparency in governmental proceedings but also serves as a linchpin in fortifying public trust in elected representatives. As cryptocurrency assumes an increasingly pivotal role in the global financial landscape, it becomes imperative for legislators to address the regulatory complexities associated with its ownership among government officials.

The parallels drawn between the passage of the Ethics in Government Act of 1978 and the current landscape of cryptocurrency disclosure laws underscore the enduring need for transparency, accountability, and ethical conduct within government institutions. Just as the EIGA sought to rectify discrepancies and rebuild public trust in the aftermath of ethical lapses, contemporary initiatives like the Cryptocurrency Accountability Act and the proposed Ban Stock Trading for Government Officials Act represent pivotal steps toward restoring faith in governance. With the evolving financial landscape and the growing prominence of cryptocurrency, the imperative for robust oversight and regulation becomes ever more apparent. By mandating the disclosure of crypto holdings and implementing stringent measures to mitigate conflicts of interest, policymakers can reinforce the foundation of democratic principles and reaffirm the integrity of public service. As history has shown, transparency is not just a matter of compliance, but a cornerstone of democratic governance, essential for fostering a climate of trust and accountability between citizens and their elected representatives.

A. Current Status

The Cryptocurrency Accountability Act was introduced in the House of Representatives on July 27, 2023, and it was referred to the House Committee on House Administration on the same day.¹⁶² What committee to send the bill to is decided by the speaker of the House on the advice of a nonpartisan parliamentarian, based on which committee would have proper jurisdiction over the bill.¹⁶³ The House Committee on House Administration focuses on election reform, House operations, House oversight, and capitol security.¹⁶⁴ As of April 2024, it remains in the House Committee – a common fate for bills navigating the intricate corridors of congressional bureaucracy.¹⁶⁵ Typically, the release of bills from committee requires a formal committee vote, paving the way for debates on the House floor.¹⁶⁶ Alternatively, a discharge petition, signed by the majority of House members, would thrust the bill into the limelight, bypassing the committee's deliberations, when it can be brought to the floor for consideration without a report from the committee.¹⁶⁷ However, discharge petitions are rarely successful due to the fact the petitions are usually used by a minority party on issues that can garner bipartisan support.¹⁶⁸ Failure to act on a bill essentially kills the bill and the sponsor of the bill would need to reintroduce the bill the next congressional session to have it considered again.¹⁶⁹

B. Argument

The passage of the Cryptocurrency Accountability Act is paramount for ensuring transparency, accountability, and ethical conduct among government officials in the digital age. Just as the Ethics in Government Act of 1978 sought to rectify discrepancies and rebuild public trust, this bill addresses the emerging complexities of cryptocurrency ownership within government ranks. With the current lack of mandatory disclosure laws for cryptocurrency assets, there exists a glaring gap in accountability across branches of government. The OGE has already mandated executive branch employees to disclose their crypto holdings, recognizing cryptocurrencies as property for investment or income purposes. This requirement ensures consistency across agencies and aligns with existing disclosure laws.

Moreover, in light of recent scandals and widespread skepticism surrounding cryptocurrency, the need for legislative action is more pressing than ever. The American public's lack of confidence in governmental institutions, compounded by concerns over conflicts of interest and ethical lapses, underscores the urgency for initiatives like the Cryptocurrency Accountability Act. The proposed ban on stock trading for government officials, supported by a significant majority of the populace, reflects a growing demand for transparency and integrity in governance.

Recent revelations regarding congressional involvement in crypto-related investments further highlight the necessity for stringent measures to restore public trust. The OGE’s warnings about potential conflicts of interest and the prohibition of involvement in crypto regulation for employees with crypto holdings mirror the principles behind the Ethics in Government Act.

In the current legislative process, the Cryptocurrency Accountability Act remains in the House Committee on House Administration, a common fate for bills navigating congressional bureaucracy. However, its eventual release from committee or the rare success of a discharge petition would pave the way for debates on the House floor. Failure to act on this bill would perpetuate the existing gap in accountability and erode public trust further. Therefore, it is imperative for policymakers to prioritize the passage of this bill to reinforce democratic principles and reaffirm the integrity of public service.

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SEC Adopts Major Changes to SPAC Rules

By Guy P. Lander, Paul J. Brown III, Louie A. Ayash and Guy Ben-Ami

On Jan. 24, 2024, the Securities and Exchange Commission (SEC) adopted final rules to enhance disclosures and provide additional investor protections in initial public offerings (IPOs) for special purpose acquisition companies (SPACs). The new rules are intended for SPACs and later business combinations between SPAC IPOs and target companies (de-SPAC transactions). Generally, the final rules follow the proposed rules issued by the SEC four years ago in March 2020, but with some significant departures. The SEC did not adopt final rules addressing the status of potential statutory underwriters in de-SPAC transactions, nor did they adopt a safe harbor from the “investment company” definition under the Investment Company Act of 1940 for SPACs.

The final rules became effective on July 1, 2024.

The final rules significantly affect SPACs as summarized below.

1. Enhanced Disclosure and Enhanced Investor Protection

The SEC adopted a new Subpart 1600 to Regulation S-K to provide specialized disclosure requirements for SPACs regarding the sponsor, potential conflicts of interest, and dilution. Subpart 1600 now requires enhanced disclosure for de-SPAC transactions, including disclosure of any determination required to be made by the SPAC’s board of directors in relation to a de-SPAC transaction.

A. Sponsors

Item 1603(a) requires additional disclosure about the sponsor, its affiliates and any promoters of the SPAC, including disclosure of the following:

- Their experience, material roles, and responsibilities and any agreement, arrangement or understanding: (1) between the sponsor and the SPAC, its executive officers, directors or affiliates, in determining whether to proceed with a de-SPAC transaction, and (2) regarding the redemption of outstanding securities;
- The controlling persons of the sponsor and any persons who have direct and indirect material interests in the sponsor;
- A table describing the material terms of any lock-up agreements with the sponsor and its affiliates;

- The nature and amount of all compensation and reimbursements that has or will be paid to the sponsor, its affiliates and any promoters for all services rendered in all capacities to the SPAC and its affiliates.

B. Conflicts of Interest

Item 1603(b) requires disclosure of any actual or potential material conflict of interest between: (1) the sponsor or its affiliates or the SPAC’s officers, directors, or promoters, and (2) unaffiliated security holders. This will include disclosure of any conflict of interest in determining whether to proceed with a de-SPAC transaction and any conflict of interest arising from the manner in which a SPAC compensates the sponsor or the SPAC’s executive officers and directors, or the manner in which the sponsor compensates its own executive officers and directors. Additionally, Item 1603(c) requires disclosure regarding the fiduciary duties each officer and director of a SPAC owes to other companies.

C. Dilution

Items 1602 and 1604 require additional disclosure about the potential for dilution in: (1) registration statements filed by SPACs, including those for initial public offerings, and (2) de-SPAC transactions. Sources of dilution may include sponsor compensation, underwriting fees, shareholder dilution, outstanding warrants, convertible securities and PIPE financings.

D. Background of and Reasons for the De-SPAC Transaction; Terms and Effects

Item 1605 requires disclosure of the background, material terms, and effects of the de-SPAC transaction, as well as the SPAC sponsor’s, officers’, and directors’ material interests in the de-SPAC transaction or any related financing transaction and any redemption or appraisal rights of security holders of the SPAC.

E. Board Determination About the De-SPAC Transaction

Item 1606(b) requires disclosure of any determination required to be made by the SPAC’s board of directors as to whether the de-SPAC transaction is advisable and in the best interests of the SPAC and its shareholders. This disclosure is required only to the extent such a determination is required by the law of the jurisdiction where the SPAC is organized.

Any board determination disclosure must be supplemented by a discussion of the material factors the board of directors considered in making its determination. Here, the SEC declined to adopt the stricter standard proposed, which would have required all SPACs to disclose a reasonable belief regarding the fairness of the proposed business combination and any related financing transactions to unaffiliated security holders. Item 1606(a) also requires disclosure of whether any director voted against, or abstained from voting on, approval of the de-SPAC transaction or any related financing transaction, and if so, identifying the director and, if known after making a reasonable inquiry, the reasons for the vote against the transaction or abstention. The final rules may thus result in SPACs not using a target company's projections to assess a transaction or for marketing purposes, and SPACs may decide against obtaining fairness opinions in connection with de-SPAC transactions because of this required disclosure coupled with the enhanced disclosure requirements related to any projections used in a de-SPAC transaction.

F. Reports, Opinions and Appraisals

Item 1607(a) requires disclosure about whether or not the SPAC or its sponsor has received any report, opinion, or appraisal obtained from an outside party relating to the consideration or the fairness of the consideration to be offered to security holders or the fairness of the de-SPAC transaction or any related financing transaction to the SPAC, the sponsor or security holders who are not affiliates. Item 1607(c) requires all such reports, opinions or appraisals to be filed as exhibits to the applicable SEC forms for the de-SPAC transaction. Therefore, any such report, opinion or appraisal must be filed as an exhibit to the Form S-4, Form F-4 and Schedule TO for the de-SPAC transaction or included in the Schedule 14A or 14C for the transaction, as applicable.

G. Re-Determining Smaller Reporting Company Status After Consummating the De-SPAC Transaction

The final rules require a smaller reporting company (SRC) to re-determine its status as a smaller reporting company within four business days following the consummation of the de-SPAC transaction. The post-de-SPAC company must reflect the redetermined status in its filings beginning 45 days after consummating the de-SPAC transaction. This re-determination of smaller reporting company status would occur before the post-business combination company makes its first SEC filing but, after the filing of its Super Form 8-K (i.e., the Form 8-K with Form 10 information), with the public float threshold measured and the revenue threshold determined by using the annual revenues of the private operating company as of the most recently completed fiscal year for which audited financial statements are available. Generally, this would require SPACs that initially qualified as SRCs to provide

more comprehensive disclosures (such as three years of financial statements and quantitative and qualitative information about market risk) earlier following a de-SPAC transaction than under existing rules (subject to potential EGC disclosure accommodations).

2. Aligning De-SPAC Transactions With SPAC IPOs

SEC Chairman Gary Gensler stated that the final rules are intended to “help ensure that the rules for SPACs are substantially aligned with those of traditional IPOs.” The final rules also amend the current “blank check company” definition to clarify that SPACs cannot rely on the safe harbor provision under the Private Securities Litigation Reform Act of 1995, as amended (PSLRA), when marketing a de-SPAC transaction.

A. Target Company as Co-Registrant

The final rules require that the SPAC and the target company be treated as co-registrants on Form S-4 and Form F-4 registration statements filed by the SPAC for a de-SPAC transaction. Accordingly, this would make the target company a signatory to the registration statement, as well as its principal executive officer, principal financial officer, controller or principal accounting officer, and a majority of the board of directors or persons performing similar functions of the target company. As a result, these parties may be held liable under Section 11 of the Securities Act of 1933, as amended (the “Securities Act”), for any material false statements or misleading omissions in the Form S-4 or Form F-4, subject to a due diligence defense for all parties other than the SPAC and the target company. Therefore, target companies assessing a de-SPAC transaction should consider whether its current director and officer liability insurance is sufficient before the filing of an initial Form S-4 or Form F-4 for its de-SPAC transaction given the potential for increased liability related to the target's disclosures.

B. Minimum Dissemination Period

The final rules require a minimum dissemination period of 20 calendar days (or the maximum period allowable by the SPAC's jurisdiction, if that period is less than 20 calendar days) for prospectuses and proxy or information statements filed in a de-SPAC transaction.

C. Protection for Projections Eliminated

PSLRA provides a safe harbor for forward-looking statements under the Securities Act and the Securities Exchange Act of 1934, as amended (the “Exchange Act”). However, the safe harbor is not available when a forward-looking statement is made in an IPO or an offering by a blank check company. Under the final rules, the SEC adopted a new definition of “blank check company” for purposes of the PSLRA, to clarify

that the statutory safe harbor is not available for forward-looking statements, such as projections, made in de-SPAC transactions. The unavailability extends to statements about the projections of target private operating companies in these transactions. The lack of the PSLRA safe harbor, especially coupled with enhanced disclosure requirements relating to projections under the final rules, may lead to changes in the presentation of projections and assumptions, or the abandonment of projections in a SPAC board's evaluation of a potential de-SPAC target. That would further undermine the viability of the de-SPAC transaction as an alternative to traditional IPOs for target companies that do not have a lengthy operating history. However, the judicially created “bespeaks caution” doctrine, recognized in numerous federal circuits, might provide protections for defendants, depending on the specific facts and circumstances.

3. Business Combinations Involving Shell Companies

The final rules deem a business combination involving a reporting shell company and a private operating company as a “sale” of securities under the Securities Act, and amend the financial statement requirements for transactions involving shell companies.

A. Rule 145(a)

New Rule 145(a) deems any business combination of a reporting shell company involving another entity that is not a shell company to involve a sale of securities to the reporting shell company's shareholders. This will treat the reporting shell company investors as having exchanged their security representing an interest in the reporting shell company for a new security representing an interest in the combined operating company. By deeming such transactions to be a “sale” within the meaning of Section 2(a)(3) of the Securities Act, Rule 145(a) will impose Securities Act disclosure and liability provisions on business combinations involving reporting shell companies. Rule 145(a) will apply to all reporting shell companies (other than a “business combination related shell company,” as defined in Rule 405 under the Securities Act and Rule 12b-2 under the Exchange Act), and not just SPAC transactions. It will also apply even when the shell company's shareholders are making no voting or other investment decision for the transaction.

C. Financial Statement Requirements in Business Combinations Involving Shell Companies

The SEC adopted updates to Regulation S-X and related amendments intended to align the financial statement reporting requirements more closely in business combinations involving a shell company and a private operating company with those in traditional initial public offerings.

- **Number of Years of Financial Statements.** If the SPAC is an EGC and the target company is an EGC, the target would be permitted to report two years of financial statements, without regard as to whether or not the shell company has filed its first annual report. Three years of financial statements would still be required for the private operating company when it exceeds both the smaller reporting company and EGC revenue thresholds;
- **Audit Requirements of Predecessor.** Rule 15-01(a) requires a target private operating company to have its financial statements examined by an independent accountant in accordance with PCAOB standards;
- **Age of Financial Statements of the Predecessor.** Rule 15-01(c) provides that the age of financial statements for a private operating company that will be the predecessor to a shell company in a registration statement or proxy statement will be based on whether the private operating company would qualify as a smaller reporting company if it were filing its own initial registration statement;
- **Acquisitions of Businesses by a Shell Company Registrant or Its Predecessor That Are Not or Will Not Be the Predecessor.** The financial statements of a target private operating company that is or will be the predecessor to a shell company registrant are required in registration statements or proxy statements related to the business combination. The financial statements of any other businesses, besides the predecessor, that have been, or are probable to be, acquired may also be required.
 - Rule 15-01(d) of Regulation S-X applies Rules 3-05 and 8-04 (and Rule 3-14 for a real estate operation), which are the current provisions for the requirements relating to the financial statements of businesses acquired or to be acquired, to acquisitions of businesses by a shell company registrant, or its predecessor, that are not or will not be the predecessor to the registrant. This new rule will be consistent with the current market practice of applying Rule 3-05 (or Rule 8-04) to acquisitions by the target private operating company in a de-SPAC transaction.
 - Currently, Rule 1-02(w) requires the financial information of the registrant, which may be a shell company, to be used as the denominator to determine significance. Because a shell company has nominal activity, applying this test results in limited to no sliding scale for business acquisitions, including those made by the private operating company that will be the predecessor to the shell company,

because every acquisition would be significant and thus require financial statements. An amendment to Rule 1-02(w) of Regulation S-X will now require that significance of the acquired business be calculated using the private operating company's financial information as the denominator instead of that of the shell company registrant.

- Rule 15-01(d)(2) specifies that the financial statements of the acquired business omitted from the previously-filed registration, proxy, or information statement (i.e., financial statements of a probable of being acquired or recently acquired business omitted from a registration, proxy, or information statement because its significance is measured at 50% or less (or Rule 3-14(b)(3)(ii) for a real estate operation)) will be required in an Item 2.01(f) Form 8-K filed with Form 10 information within 75 days after closing the acquisition.

- **Financial Statements of a Shell Company Registrant After the Combination with Predecessor.** Rule 15-01(e) allows a registrant to exclude the financial statements of a shell company, including a SPAC, for periods before the acquisition once the following conditions have been met: (1) the financial statements of the shell company have been filed for all required periods through the acquisition date, and (2) the financial statements of the registrant that were filed with the SEC include the period in which the acquisition was consummated. The financial statements of the SPAC will be required in all filings (including registration statements and the Form 8-K with Form 10 information filed following the de-SPAC transaction) before the filing of the first periodic report that includes those post-business combination financial statements.

4. Enhanced Projections Disclosures

The final rules amend the SEC's guidance on the presentation of projections in any filings with the SEC (not only on de-SPAC transactions, but for all projections filed with the SEC) and adds new guidance only for de-SPAC transactions, in both instances to address the reliability of those projections.

A. Item 10(b) of Regulation S-K

The SEC amended Item 10(b) to support the SEC's view that projected financial information included in filings subject to Item 10(b) must have a reasonable basis. Item 10(b) states that:

- Any projected measures that are not based on historical financial results or operational history should be clearly distinguished from projected measures that are based on historical financial results or operational history;

- Projections that are based on historical financial results or operational history must be presented with such historical measure or operational history having equal or greater prominence; and
- The presentation of projections that include a non-GAAP financial measure should include a clear definition or explanation of the measure, a description of the GAAP financial measure to which it is most closely related, and an explanation why the non-GAAP financial measure was used instead of a GAAP measure;
- Item 10(b) has also been amended to state that its guidance applies to any projections of future economic performance of the registrant and other persons, such as the target company in a business combination, that are included in the registrant's SEC filings.

B. Item 1609 of Regulation S-K

The SEC adopted Item 1609 of Regulation S-K which applies only to de-SPAC transactions, and requires a registrant to provide the following disclosures:

- For any projections disclosed by the registrant, the purpose for which the projections were prepared and the party that prepared the projections;
- All material bases of the disclosed projections and all material assumptions underlying the projections, and any factors that may materially affect such assumptions (including a discussion of any factors that may cause the assumptions to be no longer reasonable, material growth rates or discount multiples used in preparing the projections, and the reasons for selecting such growth rates or discount multiples); and
- Whether the disclosed projections still reflect the view of the board or management of the SPAC or target company, as applicable, as of the date of the filing. If not, then a discussion of the purpose of disclosing the projections and the reasons for any continued reliance by the management or board on the projections.

5. Status of SPACs Under the Investment Company Act of 1940

Under proposed Rule 3a-10, a safe harbor would have been provided from the definition of "investment company" under Section 3(a)(1)(A) of the Investment Company Act for SPACs, which would have excluded certain SPACs from being defined and regulated as investment companies. However, the SEC declined to adopt proposed Rule 3(a)-10 and instead provided guidance as to which facts and circumstances are relevant to investment company classification using the five Tonopah factors employed in the standard analysis. As a result, SPACs should carefully assess and monitor their activities, and consider changing their operations if

necessary to bring them into compliance with the exclusion from the Investment Company Act.

A. Nature of SPAC Assets

A SPAC will less likely be considered an investment company if the SPAC's assets are limited to government securities, government money market funds and cash items before the completion of the de-SPAC transaction and those assets may not at any time be acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.

B. Management Activities

A SPAC will more likely be an investment company if the SPAC's officers, directors and employees fail to actively seek a de-SPAC transaction or spend a considerable amount of time actively managing the SPAC's portfolio for the primary purpose of achieving investment returns, which would be indicative of investment company status.

C. Duration Limitations

The SEC's guidance discusses how the longer a SPAC takes to complete a de-SPAC transaction the more likely it could qualify as an investment company. Rule 3a-2 under the Investment Company Act provides a one-year safe harbor for "transient investment companies." And blank-check companies under Investment Company Act Rule 419 are not investment companies because their duration is limited to 18 months. Based on these timelines, SPACs operating beyond 12 or 18 months should assess whether they otherwise might qualify as investment companies.

D. Holding Out

A SPAC that markets itself like an investment company is likely to be considered to be an investment company. Additionally, if a SPAC markets itself as an alternative to an investment in a mutual fund or an opportunity to invest in treasury securities or money market funds, then it will likely be considered to be an investment company.

E. Merging with an Investment Company

A SPAC that engages or proposes to engage in a de-SPAC transaction with an investment company, such as a business development company or a closed-end fund, will "likely" be considered an investment company under Section 3(a)(1)(A).

6. Underwriter Status and Liability at De-SPAC Transaction

Proposed Rule 140(a) provided that a person who has acted as an underwriter in a SPAC initial public offering ("SPAC IPO underwriter") and takes steps to facilitate the de-SPAC transaction, or any related financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transac-

tion, will be deemed to be an "underwriter" engaged in the distribution of the securities of the surviving public entity in a de-SPAC transaction under Section 2(a)(11) of the Securities Act. This proposed rule would have imposed liability on SPAC IPO underwriters under Section 11 and 12(a)(2) of the Securities Act, subject to a due diligence defense, for material false statements and misleading omissions in the de-SPAC registration statement. However, the SEC declined to adopt proposed Rule 140a, because it believes the term "underwriter" does not have "unlimited applicability."

The SEC reiterated that it intends to follow "longstanding" practices of applying the relevant statutory terms "distribution" and "underwriter" broadly and flexibly, as warranted by the applicable facts and circumstances. Accordingly, the SEC stated that it may find a "statutory underwriter" where "someone is selling for the issuer or participating in the distribution of securities in the combined company to the SPAC's investors and the broader public, even though it may not be named as an underwriter in any given offering or may not be engaged in activities typical of a named underwriter in traditional capital raising." As a result of the Rule 140(a) proposal and the possible liability described above, SPACs and target companies should continue to expect extensive diligence requests from financial institutions, advisors, and their counsel in connection with a de-SPAC transaction. This typically includes requests from investment banks that advisors to a SPAC and its target provide negative assurance and comfort letters in connection with the de-SPAC transaction, and other related changes to the de-SPAC transaction process that add complexity, time, and cost.

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Coordinated DOJ, FDIC and OCC Final Actions on Bank Merger Policy

The Attorneys at Sullivan & Cromwell

Summary

On Sept. 17, 2024, in coordinated successive releases, both the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) adopted final policy statements (the “Final FDIC SOP,” the “Final OCC SOP”) on bank merger transactions under the Bank Merger Act of 1960.¹ Additionally, the U.S. Department of Justice announced its “withdrawal from” the 1995 Bank Merger Guidelines explaining that the DOJ will use its 2023 Merger Guidelines as the “sole and authoritative statement across all industries,” including banking. The DOJ also issued an addendum (the “Banking Addendum,” addressing application of the 2023 Merger Guidelines to the banking industry.² The Final FDIC SOP will apply primarily to mergers where the surviving bank is a small bank, because relatively few large banks today are state nonmember banks (which have the FDIC as the principal federal regulator).³ The Final OCC SOP will apply to mergers where the surviving bank is a national bank. The new DOJ guidelines apply to all bank mergers.

These actions follow (i) the FDIC’s request for comment (the “2024 FDIC RFC”)⁴ issued on March 21, 2024, regarding proposed revisions to its Statement of Policy on Bank Merger Transactions (the “Proposed FDIC SOP”), which received 23 substantive written comments,⁵ (ii) the OCC’s notice of proposed rulemaking issued on January 29, 2024 (2024 OCC NPR),⁶ regarding proposed amendments to its regulations governing business combination applications and the adoption of a draft policy statement on business combinations as an annex to such regulations (the “Proposed OCC SOP,” and together with the Proposed FDIC SOP, the “Proposed SOPs”), which received 34 substantive written comments,⁷ and (iii) the DOJ’s initial request soliciting public comment on its bank merger competitive review guidelines issued on September 1, 2020 (2020 DOJ RFC)⁸ and subsequent request for additional public comment on December 17, 2021 (the “2021 DOJ RFC,” and together with the 2020 DOJ RFC, the “DOJ RFCs”).⁹

The Final SOPs are substantially similar to the proposals, with certain limited adjustments in response to public comments. As described below, (i) the Final FDIC SOP implements notable changes to the FDIC’s decades-long policy¹⁰ on key aspects of its bank merger-related regulatory review

framework, including with respect to the scope of its jurisdiction under the Bank Merger Act, its analysis of the statutory factors,¹¹ and certain process-related expectations,¹² and (ii) the OCC’s final rule (the “OCC Final Rule,”) removes the expedited review and streamlined application procedures governing business combination applications from Part 5 of its regulations and adds the Final OCC SOP as Appendix A to Part 5, which most notably reflects an indicator-based framework for evaluating the statutory factors.

Finally, the DOJ’s withdrawal from the 1995 Bank Merger Guidelines is in keeping with recent remarks by DOJ officials criticizing the 1995 Bank Merger Guidelines. Given the generality of the 2023 Merger Guidelines and the sparse nature of the Banking Addendum, however, the withdrawal leaves unanswered important questions about how the DOJ will fulfill its congressional mandate to advise the banking regulators in their review of proposed banking transactions and DOJ’s own enforcement intentions. DOJ’s application of the 2023 Merger Guidelines to actual mergers (both banking and non-banking) will thus be an important development to watch. For instance, in the 2023 Merger Guidelines the DOJ stated that “[m]arkets with [a Herfindahl-Hirschman Index] greater than 1,800 are highly concentrated, and a change of more than 100 points is a significant increase” – as opposed to a 200-point increase¹³ under the 1995 Bank Merger Guidelines – and that “[a] merger that creates or further consolidates a highly concentrated market that involves an increase in the HHI of more than 100 points is presumed to substantially lessen competition or tend to create a monopoly,” even though the DOJ cited no precedent either by a court or a DOJ consent decree concluding that there had been competitive harm from a merger resulting in a change in the HHI anywhere near that threshold.¹⁴ Notably, the DOJ’s withdrawal from the 1995 Bank Merger Guidelines – which utilized screens developed together by the DOJ and “the banking agencies” is that it was not accompanied by a similar statement from the Board of Governors of the Federal Reserve System, which is the banking agency with the most well-developed precedent addressing the competitive review of bank mergers. The potential for divergent approaches to be adopted, and divergent conclusions reached, as between the DOJ and the Federal Reserve will thus be an important development to watch in upcoming mergers.



Background

Since 2020, the FDIC, OCC and DOJ have signaled that they were revisiting their approach to reviewing bank merger transactions, and that they would work with each other as well as the Federal Reserve on updates to their respective analytical frameworks related to these transactions.

FDIC Bank Merger Policy

The Prior FDIC SOP was last published for comment in 1997 and was revised in 2002 and 2008 without being issued for public comment to reflect, among other things, the anti-money-laundering statutory factor and amendments to the Bank Merger Act resulting from the Financial Services Regulatory Relief Act of 2006. In March 2022, the FDIC issued a request for information on a wide range of issues relating to bank merger transactions (the “2022 FDIC RFI”).¹⁵ In November 2023, FDIC Chairman Martin J. Gruenberg, in his testimony to the Senate Committee on Banking, Housing, and Urban Affairs, noted that “[a]lthough there has been a significant amount of consolidation in the banking sector over the last 30 years, facilitated in part by mergers and acquisitions, there has not been a significant review of the implementation of the [Bank Merger Act] by the banking agencies in that time” and that “[t]he FDIC [was] evaluating and considering the comments received [as part of the 2022 FDIC RFI] as it consider[ed] changes to the merger review framework, as appropriate.”

In March 2024, the FDIC took a step toward changing its bank merger review framework by issuing the 2024 FDIC RFC soliciting public comment on all aspects of the Proposed FDIC SOP¹⁶ and requesting comments on 39 enumerated

sets of questions on a broad set of topics. Public reaction to the Proposed FDIC SOP, including by members of the FDIC Board, was mixed. On the one hand, Chairman Gruenberg stated that he “strongly support[ed]” the Proposed FDIC SOP and its publication for public comment.¹⁷ Similarly, Consumer Financial Protection Bureau Director and FDIC Director Rohit Chopra remarked that the Proposed FDIC SOP would “bring analytical rigor to merger review and better align the agency’s framework with the statute” and address the “harms from the permissive, pro-merger policy posture of recent decades.”¹⁸ On the other hand, FDIC Vice Chairman Travis Hill remarked that he believed the Proposed FDIC SOP “move[d] in the wrong direction, [and would] potentially mak[e] the [FDIC’s regulatory review] process [for merger transactions] longer, more difficult, and less predictable.”¹⁹ Similarly, FDIC Director Jonathan McKernan stated that he was “unable to support [the Proposed FDIC SOP] because it reflect[ed] and would implement a bias against bank mergers that is bad policy and contrary to law.”²⁰ Comments from the leaders of the other federal banking agencies also varied. For example, Acting Comptroller Michael Hsu (also a member of the FDIC Board) generally supported the Proposed FDIC SOP, asserting that it was “broadly consistent” with the Proposed OCC SOP issued in January 2024, while noting a divergence in the agencies’ respective approach to the use of non-standard conditions.²¹

OCC Business Combinations Policy

During a speech at the Brookings Institute in May 2022, Acting Comptroller Hsu noted that “the frameworks for analyzing bank mergers need updating” because “[w]ithout enhancements, there is an increased risk of approving merg-

ers that diminish competition, hurt communities, or present systemic risks.” In addition, in February 2023 then-Senior Deputy Comptroller and Chief Counsel Benjamin W. McDonough delivered opening remarks for the OCC Bank Merger Symposium on behalf of Acting Comptroller Hsu during which he reiterated the Acting Comptroller’s views that “[the OCC] needs to build a better mousetrap so that healthy mergers get approved while unhealthy mergers get rejected,” and to do so the OCC needs to revise its analytical framework to deepen its evaluation of a bank merger’s effect on market concentration, financial stability and the convenience and needs of the communities served.

In furtherance of this goal, in January the OCC issued the 2024 OCC NPR, which included the Proposed OCC SOP. The Acting Comptroller’s remarks accompanying the announcement of the 2024 OCC NPR underscored his desire to develop a “macro view” of the banking system – one that holistically evaluates the impact of bank mergers on the banking system and the U.S. economy – as a way to improve “transparency and trust” in the OCC’s “micro,” case-by-case approach to reviewing bank merger applications.²²

DOJ Bank Merger Policy

The 1995 Bank Merger Guidelines describe a detailed framework collaboratively developed by “the banking agencies and the [DOJ]” to “speed” their review of banking mergers and “reduce regulatory burden on the banking industry.”²³ Toward the end of the Trump administration, the DOJ issued the 2020 DOJ RFC seeking public comments on the need to revise the 1995 Bank Merger Guidelines to reflect “emerging trends in the banking and financial services sector and modernize its approach to bank merger review under the antitrust laws.”²⁴ The 2020 DOJ RFC solicited public comment on “six specific questions, including whether any new guidance should be bank-specific, whether any new bank merger guidance should be jointly issued [with the banking agencies], whether the 1800/200 [HHI]screen should be updated, and whether there should be a *de minimis* exception.”²⁵

Subsequently, in furtherance of President Biden’s Executive Order on Promoting Competition in the American Economy (the “2021 Executive Order,”) the DOJ updated its call for public comment with its issuance of the 2021 DOJ RFC, which built on the comments received on the 2020 DOJ RFC and “focuse[d the updated call for comment] on whether bank merger review is currently sufficient to prevent harmful mergers and whether it accounts for the full range of competitive factors appropriate under the laws.”²⁶

In his June 2023 remarks at the Brookings Institution, Assistant Attorney General Jonathan Kanter observed that “the time is indeed ripe for us to re-examine how we assess bank mergers under the statutory framework that Congress

has enacted” and that the DOJ had been “engaged in productive discussions” with the federal banking agencies to reassess the prevailing approach to bank merger review and enforcement “given current market realities.” Later, in July 2023, the DOJ (together with the Federal Trade Commission) issued for public comment generally applicable draft merger guidelines that articulated a policy that was generally more restrictive toward mergers than their prior longstanding policy. In December 2023, the DOJ and the FTC adopted the 2023 Merger Guidelines.

Neither the 2023 Merger Guidelines nor the press releases accompanying them expressly mentioned the 1995 Bank Merger Guidelines or the DOJ RFCs. In comments following release of the 2023 Merger Guidelines, however, DOJ officials have made clear their preference for the 2023 Merger Guidelines over the 1995 Bank Merger Guidelines. For instance, Assistant Attorney General Kanter described “widespread recognition” that the “mode of analysis” set forth in the 1995 Bank Merger Guidelines “is outdated” in a March 2024 conference on banking mergers.²⁷

Final FDIC SOP

The Final FDIC SOP largely reflects the same content and structure as the Proposed FDIC SOP, and was approved by the FDIC Board by a 3 to 2 vote (with Vice Chairman Hill and Director McKernan dissenting).²⁸ Separate sections discuss the statutory factors, each of which includes a declarative statement regarding the FDIC Board’s expectations with respect to a specific statutory factor as well as an accompanying narrative that describes the FDIC’s analytical considerations for the factor.

As with the Proposed FDIC SOP, certain of the stated expectations and requirements in the Final FDIC SOP appear to represent a departure from the Prior FDIC SOP guidance and past practice at the FDIC, including most notably with respect to the following areas:

- **Convenience and Needs of the Community.** Section IV (*Statutory Factors – Convenience and Needs of the Community To Be Served*) of the Final FDIC SOP retains, among other things: (i) a novel requirement for applicants to demonstrate that a resulting insured depository institution will “*better meet* the convenience and needs of the community to be served” through, among other means, higher lending limits, greater access to existing products and services, new or expanded products or services, reduced costs, or increased convenience;²⁹ (ii) a requirement for applicants to provide a greater amount of specific and forward-looking information, including three-year projections for all future branch plans, to enable the FDIC to consider how a transaction will “*better meet*” the convenience and needs of the community,

which information the FDIC will consider to be “claims and commitments” the adherence to which the agency will evaluate on an ongoing basis;³⁰ and (iii) a general expectation that the FDIC will hold public hearings for transactions where the resulting IDI will have greater than \$50 billion in total assets or for which a “significant number of [Community Reinvestment Act] protests” are received.³¹

Despite “multiple commenters” opposing these changes and asserting that the “better meet” standard is inconsistent with the clear statutory language and decades of precedent, the FDIC states that it retained this requirement because it is “consistent with Congressional intent” (citing only an excerpt of a 1966 statement from the then-Chairman of the Senate Committee on Banking and Currency regarding an agency’s evaluation of “beneficial” aspects of a merger) and with the “FDIC’s longstanding policy” (quoting a portion of the Prior FDIC SOP indicating that the FDIC will consider “the extent to which [a] proposed merger transaction is likely to benefit the general public”).³² In his dissent, Vice Chairman Hill noted that he is “unpersuaded” by this cited support in the preamble and “continue[s] to oppose imposing an affirmative burden on applicants to demonstrate the merger would *better* meet the convenience and needs of the community.”³³

- **Competition.** To “mitigate competitive concerns,” Section IV (Statutory Factors – Monopolistic or Anticompetitive Effects) of the Final FDIC SOP indicates that the FDIC may require divestitures of “business lines, branches, or portions thereof” to be completed *before* allowing bank merger transactions to be consummated,³⁴ which is different from the longstanding practice for bank mergers where the DOJ, FTC and federal banking agencies typically permit required divestitures to be completed after a bank merger’s closing.³⁵
- **Financial Stability.** Although emphasizing that “size alone is not dispositive,”³⁶ Section IV (Statutory Factors – Risk to the Stability of the United States Banking or Financial System) of the Final FDIC SOP retains the general observation that transactions resulting in institutions with \$100 billion or more in total assets are expected to be subject to “added scrutiny” by way of “additional information requests, more frequent discussions and correspondence with application parties, and supplementary meetings and discussions with regulators and community groups,”³⁷ as these are “more likely” to present potential financial stability concerns.³⁸ Regarding the retention of this framework from the Proposed FDIC SOP, Vice Chairman Hill noted that he “generally think[s] the inclusion of the \$100 bil-

lion threshold is unhelpful, even if the preamble acknowledges that it is ‘not a threshold for a presumptive denial.’”³⁹

- **Process-Related Matters.** Section II (Jurisdiction and Scope – Merger Application Adjudication) preserves the ability of the FDIC to issue a public statement detailing the agency’s concerns with a withdrawn application if “such a statement is considered to be in the public interest for purposes of creating transparency for the public and future applicants.”⁴⁰ Although the FDIC recognized commenters’ request to eliminate this aspect of the Proposed FDIC SOP and concerns regarding publicizing confidential information,⁴¹ the agency reasserted its “prerogative” to issue such public statements, which are “not expected for most transactions” and would be “fully consistent with the confidentiality requirements of applicable laws and regulations and would not disclose confidential business information of applicants.”⁴²

Additionally, consistent with the Proposed FDIC SOP, Section II (Jurisdiction and Scope) of the Final FDIC SOP reiterates the FDIC’s expansive interpretation of the types of transactions requiring FDIC approval, except that the Final FDIC SOP now expressly asserts that acquisitions of “lines of business [where] the target is no longer a viable competitor [in that line of business]” also qualify as “mergers in substance” subject to prior FDIC approval, “regardless of whether the target plans to liquidate immediately after consummating the transaction” as would occur in connection with a “true merger.”⁴³ The FDIC rejected commenters’ position that such an expansive jurisdictional assertion was inconsistent with the statutory language and structure.⁴⁴ Relatedly, the FDIC rejects state common law as precedential on the basis that “the scope of transactions subject to the [Bank Merger Act] for the purposes embodied by its statutory factors is not perfectly coextensive with the scope of transactions that qualify as de facto mergers under divergent state law doctrines for the purpose of establishing successor liability.”⁴⁵ Further, Section V (Other Matters and Considerations) of the Final FDIC SOP discusses how, in connection with its review of applications from non-banks (i.e., from an insured depository institution that is not a “bank” for purposes of the Bank Holding Company Act), banks that are not traditional community banks (e.g., monolines) and operating non-insured entities, which applications are subject to the same statutory factors as transactions between traditional banks generally, the FDIC may require a broader range of information, such as three years of audited financial statements and potentially independent appraisals or valuations of assets to be transferred to an IDI.⁴⁶

In response to public comments, the FDIC did include in the Final FDIC SOP certain limited amendments to the Proposed FDIC SOP, most importantly with respect to the

use of non-standard conditions as part of the FDIC's consideration of a Bank Merger Act application. Specifically, Section III (Application Process and Adjudication – Merger Application Adjudication) of the Final FDIC SOP clarifies the agency's position that "the imposition of [non-standard] conditions will be taken into account as part of the FDIC's consideration of [a] merger application, but will not necessarily lead to the favorable resolution of any statutory factor where the facts and circumstances are otherwise unfavorable."⁴⁷ As noted above, this is more consistent with the OCC's guidance and past practice as well as that of the Federal Reserve, and also with the FDIC's statements in Financial Resources sections of both the Proposed and Final FDIC SOPs where the agency asserts that it may impose higher than applicable capital requirements as non-standard conditions in connection with approving a particular transaction.⁴⁸

Final OCC Rule and SOP

The Final OCC Rule is substantially similar to the 2024 OCC NPR, including adopting as proposed the amendments eliminating the automatic expedited review and approval procedures that permitted certain transactions that qualified as business reorganizations,⁴⁹ or for a streamlined application,⁵⁰ to be deemed approved as of the 15th day after the comment period on the application closes.⁵¹ The OCC contended that these regulatory amendments better reflect the agency's view that any filing under the business combination regulations warrants "active OCC consideration" and should not be approved through the mere passage of time.⁵² Furthermore, the OCC observed, given its practice of removing applications from expedited review, extending its processing timeline, and requesting additional information, it did not expect that these changes would result in a meaningful change to its processing time of merger applications.⁵³

Although the Final OCC SOP was in many respects identical to the Proposed OCC SOP in the standards the agency will apply in reviewing business combinations, importantly, the Final OCC SOP reflects certain revisions to resolve confusion regarding whether the OCC intends to disapprove certain types of proposed transactions.⁵⁴ This and other key revisions incorporated in the OCC Final SOP are explained below:

- **Indicator Framework Generally.** Section I (General Principles of OCC Review) of the Final OCC SOP retains the indicator-based framework elaborating on how the OCC considers the statutory factors and certain applicant and transaction features that, in the OCC's experience, are consistent with an application approval or, alternatively, would raise supervisory or regulatory concern.⁵⁵ Numerous commenters expressed confusion about how the indicators would apply, and the OCC

acknowledged that many interpreted the Proposed OCC SOP to mean that the OCC would not approve an application if one of the positive indicators was absent. As a result, the OCC made revisions to eliminate this confusion, specifying that applications that "tend to withstand scrutiny more easily and are more likely to be approved expeditiously" generally feature all of the enumerated positive indicators, but that "these indicators are not *required* for a transaction to be approved."⁵⁶

- **Size-Based Indicators.** The Proposed OCC SOP included as a positive attribute that the resulting entity would have less than \$50 billion in total assets, which had prompted commenters' concern that this was a "ceiling for transactions consistent with approval."⁵⁷ In addition to the OCC's general clarifying change regarding the purpose of the indicators as described in the bullet above, the OCC also explained in its release that this "\$50 billion indicator merely reflects the likelihood of an expeditious approval," but that many larger transactions may also be approved.⁵⁸

Two commenters also criticized one of the positive indicators regarding a target's "combined total assets" being less than or equal to 50% of the acquirer's total assets, suggesting that the OCC meant to systematically disapprove mergers of equals.⁵⁹ In response, the OCC clarified that this indicator merely reflected the OCC's experience that transactions involving institutions of similar sizes generally required "more review," but that this "indicator is not intended to discourage mergers of equals."⁶⁰

- **G-SIBs.** The OCC also responded to commenters' concerns that the Proposed OCC SOP meant that if an acquirer is a G-SIB or subsidiary thereof, any related application would not be approved. The OCC stated that this was not the case and clarified that indicators of regulatory or supervisory concern do not preclude OCC approval.⁶¹ However, because of the OCC's stated experience that "G-SIBs are among the most complex financial institutions" and "often present supervisory issues," inclusion of this indicator was still appropriate.⁶²
- **Competition.** The OCC rejected commenters' request for more information regarding the OCC's analysis of the competition-related statutory factor, noting that Appendix A is not "the appropriate vehicle" for this detail, given the complexities of the analysis and the OCC's partnership with the DOJ.⁶³
- **General Processing Matters.** The OCC also remarked that the Appendix A was not intended to "address OCC processing issues," thereby dismissing commenters' requests for more information regarding staff review time-

lines, the disclosure of confidential supervisory information, the reasoning behind application withdrawals, internal decision-making considerations, or the practice of pre-filing meetings.⁶⁴ Specifically in response to commenters' request for more precision about application processing times, the OCC explained that it intended to make determinations "in a timely fashion, consistent with a fulsome review of applications and safety and soundness."⁶⁵

DOJ Banking Addendum

In its Banking Addendum, the DOJ pointed to the need to address a merger's potential effects on a number of subsegments of customers who purchase financial services, including "depositors," those needing "mortgages," those who visit "branch locations," corporations needing "large or bespoke financing," "[s]mall businesses," "non-profit organizations," "local stores," "economically underserved individuals," and "customers with low credit scores."⁶⁶ The DOJ did not purport to describe how competitive effects on those subsegments would be addressed, but instead pointed to the need to conduct a "market-by-market" analysis.⁶⁷ The Banking Addendum also summarized the statutory scheme relating to bank mergers and concluded by observing that "[t]he banking agencies may, at their discretion, use their own methods for screening and evaluating bank mergers."⁶⁸ Thus, unlike the 1995 Bank Merger Guidelines, the Banking Addendum does not purport to address the approach of the "banking agencies" and speaks only to the approach to be followed by the DOJ.

Analysis

The coordinated manner in which the FDIC, OCC and DOJ announced their final actions on September 17, 2024 was notable and appears to signify the culmination of the Biden Administration's directive to "revitaliz[e] merger oversight under the Bank Merger Act and the Bank Holding Company Act of 1956" pursuant to the 2021 Executive Order.⁶⁹ It is unclear, however, to what extent the Final SOPs and the as-revised 2023 Merger Guidelines will impact bank consolidation activity or the respective agencies' application review processes.

A few additional observations:

- **Final FDIC SOP.** The FDIC suggests the aim of the Final FDIC SOP is to "provide transparency"⁷⁰ on its bank merger policy. As noted above, however, certain aspects of the Final FDIC SOP – particularly the novel guidance relating to the "convenience and needs" and competition-related statutory factors and application withdrawals – go beyond merely clarifying existing policy. These changes represent a significant shift vis-à-

vis not only the FDIC's, but also from the OCC's and Federal Reserve's, long-established approach to evaluating and processing applications under the Bank Merger Act.⁷¹ A lack of interagency coordination in such a critical policy area creates greater uncertainty for industry participants and may have a chilling effect on bank merger transactions where the resulting IDI is a state nonmember bank.⁷² Indeed, Director McKernan's dissent asserts that "the [FDIC's] decision to reject [] concerns raised by the commenters on the [Proposed FDIC SOP] confirms that [the Final FDIC SOP] does indeed implement a bias against bank mergers that is bad policy and contrary to law."⁷³

Additionally, despite receiving comments regarding the extensive delays associated with the FDIC's bank merger review process,⁷⁴ consistent with the Proposed FDIC SOP, the Final FDIC SOP provides applicants with no guidance on if or how the agency plans to institute predictable staff review procedures or approval deadlines.

- **Final OCC SOP.** Importantly, the OCC addressed and dispelled the overarching concern that the OCC would approve only applications that included all the enumerated positive indicators. The OCC's revisions in the Final OCC SOP clarify that the OCC did not intend to change its existing policies and practice and that, specifically, the agency did not intend to prohibit mergers of equals, transactions resulting in an institution with more than \$50 billion in assets, or any transaction involving a G-SIB or a subsidiary thereof. This update provides helpful clarity to the market.

Still, and consistent with the Final FDIC SOP, the OCC's final rulemaking did not provide any further clarity or comfort regarding the lengthy period of time for reviewing bank mergers by all the agencies. Despite multiple comments regarding this concern, the OCC responded only that it is "mindful of the effects of the length of review periods on all relevant parties."⁷⁵ Indeed, as noted above, the OCC states that the removal of the automatic expedited review and streamlined application processes will have only a *de minimis* effect on its processing times, given its historical practice of requesting additional information or extending review periods. However, there is little in the Final OCC SOP or accompanying regulation changes to suggest that the processing times for merger applications will actually improve.

Acting Comptroller Hsu, although commenting on the Final FDIC SOP, observed that "we must also be open to embracing and approving mergers where strong banks that have earned the trust of their communities

and regulators seek to acquire weaker ones and have credible plans and capabilities to improve them.”⁷⁶

- **Final DOJ Bank Merger Guidelines.** The DOJ’s rejection of its longstanding approach to bank mergers and the relatively high-level discussion in the Banking Addendum of the application of the 2023 Merger Guidelines to bank mergers may leave unanswered important questions that banks will need to consider carefully in their strategic plans.

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters.

Endnotes

1. 12 U.S.C. § 1828(c).
2. DoJ, Press Release: *Justice Department Withdraws from 1995 Bank Merger Guidelines* (Sept. 17, 2024).
3. As discussed below, the Final FDIC SOP also applies to what the FDIC terms “in substance” mergers of non-banks into all insured banks.
4. FDIC, Request for Comment on Proposed Statement of Policy on Bank Merger Transactions, 89 Fed. Reg. 29222 (Apr. 19, 2024); see also our prior memorandum regarding the 2024 FDIC RFC here.
5. See Memorandum to the FDIC Board of Directors, Final Statement of Policy on Bank Merger Transactions (Sept. 17, 2024) at 3. The public comment period for the 2024 RFC closed on June 18, 2024.
6. See OCC Final SOP at 3; OCC, *Notice of Proposed Rulemaking: Business Combinations under the Bank Merger Act*, 89 Fed. Reg. 10010 (Feb. 13, 2024). See also our prior memorandum regarding the 2024 OCC NPR.
7. OCC Final SOP at 3. The public comment period for the 2024 RFC closed on June 15, 2024.
8. DoJ, Antitrust Division Seeks Public Comments on Updating Bank Merger Review Analysis (Sept. 1, 2020).
9. DoJ, Antitrust Division Seeks Additional Public Comments on Bank Merger Competitive Analysis (Dec. 17, 2021).
10. FDIC, Statement of Policy on Bank Merger Transactions, 63 Fed. Reg. 44761 (Aug. 20, 1998) (as amended) (the “Prior FDIC SOP”).
11. The statutory factors the FDIC, OCC and Federal Reserve are required to consider in connection with their review of applications pursuant to the Bank Merger Act include competitive effects, financial and managerial resources, future prospects, convenience and needs of the community to be served, effectiveness in combatting money laundering, and the risk to the stability of the United States banking or financial system. See 12 U.S.C. § 1828(c).
12. The FDIC did not adopt final revisions to its supplemental section to the Interagency Bank Merger Act Application form as part of its approval of the Final FDIC SOP, which revisions were the subject of a separate FDIC information request earlier this year. See FDIC, *Agency Information Collection Activities: Proposed Collection Renewal; Comment Request*, 89 Fed. Reg. 29245 (Apr. 19, 2024).
13. See 1995 Bank Merger Guidelines at 1-2.
14. See 2023 Merger Guidelines at 5-6.
15. See our prior memorandum regarding the FDIC’s 2022 RFI on bank merger transactions.
16. 2024 FDIC RFC at 13.
17. Statement by Martin J. Gruenberg, Chairman, FDIC, on Proposed Statement of Policy on Bank Merger Transactions (Mar. 21, 2024).
18. Prepared Remarks of CFPB Director Rohit Chopra at the Peterson Institute for International Economics Event on Revitalizing Bank Merger Review (Mar. 21, 2024).
19. Statement by Vice Chairman Travis Hill on the FDIC’s Proposed Statement of Policy on Bank Merger Transactions (Mar. 21, 2024).
20. Statement by Jonathan McKernan, Director, FDIC, Board of Directors, on the Proposed Statement of Policy on Bank Merger Transactions (Mar. 21, 2024).
21. OCC Press Release, *Acting Comptroller Issues Statement on the FDIC’s Proposed Statement of Policy on Bank Merger Transactions* (Mar. 21, 2024).
22. Speech, Acting Comptroller Michael Hsu, *What Should the U.S. Banking System Look Like? Diverse, Dynamic, and Balanced* (Jan. 29, 2024).
23. 1995 Bank Merger Guidelines at 1.
24. DoJ 2020 RFC at 1.
25. See DoJ press release cited in *supra* note 9.
26. *Id.*
27. Remarks of Assistant Attorney General Kanter at the Peterson Institute for International Economics Event on Revitalizing Bank Merger Review at 41:45 (Mar. 21, 2024).
28. See Statement by FDIC Vice Chairman Travis Hill on the Final Statement of Policy on Bank Merger Transactions (Sept. 17, 2024) (the “Hill Dissent”); Statement by FDIC Director Jonathan McKernan on the Final Statement of Policy on Bank Merger Transactions (Sept. 17, 2024) (the “McKernan Dissent”).
29. Final FDIC SOP at 46 (emphasis in original).
30. *Id.* at 47.
31. *Id.* at 49.
32. *Id.* at 21, notes 13 and 14.
33. Hill Dissent at 1 (emphasis in original).
34. *Id.* at 41.
35. The FDIC also expanded the content in this section as compared to the Proposed FDIC SOP to (i) clarify that it may request an IDI divesting or otherwise closing a branch in connection with a transaction to “waive any terms or conditions that preclude the ability of other IDIs to lease or purchase the property” and (ii) provide guidance regarding policies and practices relevant to transactions involving rural institutions, namely that: (x) as circumstances warrant, the FDIC will take into account certain non-bank competitors, expressly identifying credit unions, thrifts, and Farm Credit System institutions and (y) the FDIC will carefully balance the competitive effects of such a merger with the public interest served by the capacity of the resulting IDI to serve the convenience and needs of the community. *Id.* at 39, 41.
36. *Id.* at 10.
37. *Id.* at 27.
38. *Id.* at 50.
39. Hill Dissent at 1.

40. *Id.* at 38.
41. *Id.* at 15.
42. *Id.* at 15-16.
43. *Id.* at 13 and 33.
44. *Id.* at 13.
45. *Id.* at 13 (emphasis in original).
46. *Id.* at 55.
47. *Id.* at 36.
48. *Id.* at 42.
49. § 5.33(d)(3) defines a “business reorganization” as either a business combination between (i) eligible banks and eligible savings associations, or between an eligible bank or an eligible savings association and an eligible depository institution, that are controlled by the same holding company or that will be controlled by the same holding company prior to the combination; or (ii) an eligible bank or an eligible savings association and an interim national bank or interim Federal savings association chartered in a transaction in which a person or group of persons exchanges its shares of the eligible bank or eligible savings association for shares of a newly formed holding company and receives after the transaction substantially the same proportional share interest in the holding company as it held in the eligible bank or eligible savings association (except for changes in interests resulting from the exercise of dissenters’ rights), and the reorganization involves no other transactions involving the bank or savings association.
50. § 5.33(j) authorized use of a streamlined application if:
- (i) at least one party to the transaction is an eligible bank or eligible savings association, and all other parties to the transaction are eligible banks, eligible savings associations or eligible depository institutions, the resulting national bank or resulting federal savings association will be well capitalized immediately following consummation of the transaction, and the total assets of the target institution are no more than 50% of the total assets of the acquiring bank or federal savings association, as reported in each institution’s Consolidated Report of Condition and Income filed for the quarter immediately preceding the filing of the application;
- (ii) the acquiring bank or federal savings association is an eligible bank or eligible savings association, the target bank or savings association is not an eligible bank, eligible savings association, or an eligible depository institution, the resulting national bank or resulting Federal savings association will be well capitalized immediately following consummation of the transaction, and the filers in a pre-filing communication request and obtain approval from the appropriate OCC licensing office to use the streamlined application;
- (iii) the acquiring bank or federal savings association is an eligible bank or eligible savings association, the target bank or savings association is not an eligible bank, eligible savings association, or an eligible depository institution, the resulting bank or resulting Federal savings association will be well capitalized immediately following consummation of the transaction, and the total assets acquired do not exceed 10% of the total assets of the acquiring national bank or acquiring federal savings association, as reported in each institution’s Consolidated Report of Condition and Income filed for the quarter immediately preceding the filing of the application; or
- (iv) in the case of a transaction under § 5.33(g)(4) of this section, the acquiring bank is an eligible bank, the resulting national bank will be well capitalized immediately following consummation of the transaction, the filers in a pre-filing communication request and obtain approval from the appropriate OCC licensing office to use the streamlined application, and the total assets acquired do not exceed 10% of the total assets of the acquiring national bank, as reported in the bank’s Consolidated Report of Condition and Income filed for the quarter immediately preceding the filing of the application.
51. *See* Final OCC Rule at 44.
52. *Id.* at 5-6.
53. *Id.* at 5, 7-8.
54. *Id.* at 13.
55. *Id.* at 45.
56. *Id.* at 14 (emphasis in original).
57. *Id.*
58. *Id.* at 14–15.
59. *Id.* at 15.
60. *Id.*
61. *Id.* at 17.
62. *Id.* at 18.
63. *Id.* at 11.
64. *Id.* at 10.
65. *Id.* at 35.
66. Banking Addendum at 2.
67. *Id.*
68. *Id.* at 3.
69. 2021 Executive Order at 8.
70. Final FDIC SOP at 1.
71. This is notwithstanding Acting Comptroller Hsu’s remarks that the Final FDIC SOP “is broadly consistent with the [Final OCC SOP].” Statement by FDIC Director, Acting Comptroller Michael Hsu on the Final Statement of Policy on Bank Merger Transactions (Sept. 17, 2024) (the “Hsu Statement”).
72. The Final FDIC SOP does not apply to bank merger transactions where the resulting IDI is a national bank or a state member bank.
73. McKernan Statement at 1.
74. Final FDIC SOP at 16.
75. Final OCC SOP at 35.
76. *See* Hsu Statement at 1.

Inside the Courts

An Update From Skadden Securities Litigators

Spotlight

Supreme Court Mulls What PSLRA's Particularity Standard Requires

By Mark R. S. Foster and Virginia Milstead

(Editor's Note: As this issue was going to press, on December 11, 2024 the Supreme Court unexpectedly dismissed the NVIDIA case on the grounds that certiorari was improvidently granted, leaving unresolved a split between the Second (and other) Circuits and the Ninth Circuit on the two key issues presented with respect to securities law claims – what a plaintiff relying on internal documents needs to plead, and the extent to which a plaintiff may rely on expert testimony to support a securities law claim. The authors' discussion and analysis is set forth as originally written prior to the dismissal.)

Key Points

- During its 2024 term, the U.S. Supreme Court is poised to provide important guidance on the Private Securities Litigation Reform Act's (PSLRA's) particularity requirement in *NVIDIA Corp. v. E. Ohman J:or Fonder AB*.
- In *NVIDIA*, the Court will decide two related issues: (i) whether plaintiffs seeking to allege scienter under the PSLRA based on allegations about internal company documents must plead with particularity the contents of those documents, and (ii) whether plaintiffs can satisfy the PSLRA's falsity requirement by relying on an expert opinion to substitute for particularized allegations of fact.
- The justices heard arguments in the *NVIDIA* case on November 13, 2024, and expressed concern about adopting any bright-line rules.
- The justices' skepticism seemed to carry over from arguments that they heard a week earlier in another securities case, *Facebook, Inc. v. Amalgamated Bank*, for which, on November 21, 2024, the Court concluded *certiorari* was improvidently granted.

The Private Securities Litigation Reform Act (PSLRA) was enacted to heighten the pleading standards that apply to securities fraud cases. This term, the U.S. Supreme Court is poised to provide important guidance on the PSLRA's particularity requirement in *NVIDIA Corp. v. E. Ohman J:or Fonder AB*, Case No. 23-970.

In *NVIDIA*, the Court will decide two related issues: (i) whether plaintiffs seeking to allege scienter under the PSLRA based on allegations about internal company documents must plead with particularity the contents of those documents, and (ii) whether plaintiffs can satisfy the PSLRA's falsity requirement by relying on an expert opinion to substitute for particularized allegations of fact.

Background

The *NVIDIA* case emerges from a recurring pattern in securities litigation: the announcement of disappointing revenue results and downward guidance revisions following a sustained period of success. In the case under review, the plaintiffs alleged that NVIDIA fraudulently understated the extent to which its revenues for its graphics processing units (GPUs) depended on sales for crypto mining, rather than for gaming. When cryptocurrency prices fell in 2018, demand for GPUs declined, and NVIDIA's stock price also declined. In the stock price decline's wake, a securities class action was filed.

In support of their securities fraud claim, the plaintiffs alleged that contemporaneous internal NVIDIA reports regarding GPU sales contradicted public statements about them. The plaintiffs did not, however, allege the contents of any internal NVIDIA report. Instead, the plaintiffs sought to bolster their fraud claims by retaining an expert firm – the Prysm Group – which purported to estimate the amount by which NVIDIA's quarterly gaming revenues were driven by cryptocurrency miners, rather than gamers. Using generic market research, Prysm (i) estimated the overall amount of computing power needed during the relevant time period to mine cryptocurrencies, (ii) estimated how many GPUs that would require, (iii) estimated NVIDIA's market share and then (iv) multiplied the number of units implied by that market share times an estimated revenue per unit. The plaintiffs alleged that the amount by which the estimated revenue exceeded the amount NVIDIA reported in its original equipment manufacturer (OEM) segment for sales of its crypto-specific GPU product was the amount by which NVIDIA fraudulently understated its exposure to cryptocurrency mining demand.

Divided Ninth Circuit Panel Approves Use of Expert Reports

After the district court dismissed the securities fraud claim, a divided panel of the Ninth Circuit reversed in relevant part. The panel majority held that falsity was sufficiently alleged based on the revenue estimates generated by Prysm. The pan-

el majority also held that there was a strong inference of scienter because internal NVIDIA documents “would have” reflected Prysm’s *post hoc* calculations, and that NVIDIA’s CEO “would have” known about those internal documents given allegations about his “detail oriented” and “meticulous” oversight of company operations. The panel majority credited the Prysm report’s conclusion that NVIDIA underreported its crypto revenues by \$1.126 billion to observe that a “CEO who does not know the source of \$1.126 billion is unlikely to exist.”

Judge Gabriel Sanchez dissented. He opined that “the majority essentially concludes that Plaintiffs have adequately alleged falsity merely by showing that Defendants’ statements concerning cryptocurrency related revenues diverged from Prysm’s *post hoc* revenue estimates.” The PSLRA, he added, does not “allow an outside expert to serve as the primary source of falsity allegations,” especially where the expert is “without any personal knowledge of the facts on which its opinion is based.” With respect to scienter, he pointed out that the plaintiffs failed to allege the “contents” of “any internal report or data source that would have put NVIDIA’s executives on notice that their public statements were false or misleading when made, much less any internal source that corroborated Prysm’s revenue estimates.”

Circuit Split

The Ninth Circuit’s rule conflicts with the Second Circuit’s rule in *Arkansas Pub. Emps. Ret. Sys. v. Bristol-Myers Squib Co.*, 28 F. 4th 343, 354 (2d Cir. 2022), which holds that expert opinions “cannot substitute for facts under the PSLRA” unless the opinion “was based on particularized facts sufficient to state a claim for fraud.” In accord with the Second Circuit, the Fifth Circuit has held that “opinions cannot substitute for facts under the PSLRA.” *Fin. Acquisition Partners LP v. Blackwell*, 440 F.3d 278, 285-86 (5th Cir. 2006). Evidentiary complications relating to the admission of expert reports in connection with a pleading stage analysis have also supported their rejection by courts. *See id.*

NVIDIA and its *amici* have argued that the Ninth Circuit’s rule dilutes the PSLRA’s pleading standards and thereby undercuts the congressional goal of eliminating fishing expeditions brought with the hope of discovering a fraud after litigation is commenced. The PSLRA’s ability to serve as a “check against litigation by private parties” could be thwarted by a rule that permits expert opinions in lieu of particularized facts. Allowing the Ninth Circuit’s ruling to stand could, they argue, allow enterprising plaintiffs’ lawyers to manufacture disputes based on expert opinions that could not be challenged. Equally problematic is the Ninth Circuit’s apparent endorsement of allegations about internal reports without pleading details about their contents. Such lax standards

threaten to render the PSLRA a weak check on lawyer-driven litigation.

Supreme Court Hears NVIDIA Arguments

The Supreme Court heard arguments in the *NVIDIA* case on November 13, 2024. NVIDIA and its *amici* argued to the Court that the Ninth Circuit’s ruling dilutes the PSLRA’s pleading standards and provides a roadmap for plaintiffs to skirt dismissal under the PSLRA’s pleading standards by paying an expert to supposedly validate fraud claims. The PSLRA requires complaints to “state with particularity all facts” supporting the belief that a challenged “statement is misleading” and “facts giving rise to a strong inference of scienter.” NVIDIA has argued that an expert opinion is not a fact; therefore, it follows, that the expert opinion does not satisfy the PSLRA’s heightened pleading standards.

The justices expressed concern about adopting any bright-line rules. Several justices expressed skepticism towards NVIDIA’s arguments and even questioned why the Court agreed to review the case when it sounded like NVIDIA was merely seeking “error correction” rather than a new rule. Other justices wondered exactly how demanding the PSLRA’s particularity requirement is and whether the plaintiffs could be expected to plead as much detail about internal reports as NVIDIA was demanding.

Justices Toss Facebook Risk Disclosure Case

The justices’ expressed skepticism in the *NVIDIA* case seemed to carry over from arguments that they heard a week earlier in another securities case, *Facebook, Inc. v. Amalgamated Bank*, Case No. 23-98. In *Facebook*, the Court was asked to decide whether risk disclosures are false or misleading when they do not disclose that a risk has materialized in the past, even if that past event presents no currently known risk of ongoing or future business harm. Following argument, the Court issued an order stating that it had improvidently granted *certiorari* in the case. As a result, the decision on review from the Ninth Circuit in *Facebook* will stand.

The Court’s decision not to rule in the *Facebook* case will allow a circuit split to persist. In the case that had been under review, the Ninth Circuit reversed dismissal of a securities fraud claim against Facebook alleging that Facebook’s risk disclosures in its annual report – mandated by Item 105 of Regulation S-K – were materially misleading for failing to disclose that its data had been improperly harvested by Cambridge Analytica in connection with political campaigns in 2016. In a split decision, the Ninth Circuit reversed in relevant part. The majority opinion criticized Facebook for representing the risk of improper access to or disclosure of Facebook data “as purely hypothetical when that exact risk had already transpired.” A reasonable investor, the majority opinion concluded, “would have understood the risk of a

third party accessing and utilizing Facebook user data improperly to be merely conjectural.” The majority opinion reasoned that it was irrelevant that Facebook “did not yet know the extent of the reputational harm it would suffer as a result of the breach” by Cambridge Analytica.

In conflict with the Ninth Circuit’s materialized risk standard, the First, Second and Tenth Circuits have adopted a “virtual certainty test.” Under that test, those circuits hold that a company’s disclosures about risks that “could” or “may” come to fruition are potentially actionable where defendants “omitted known risks of severe magnitude” that had either materialized at the time of disclosure or where it was a “virtual certainty” that they would materialize.

In light of the Court’s decision not to rule in *Facebook*, public companies will need to proceed with caution in the face of a circuit split relating to the circumstances that will trigger securities fraud liability for statements and alleged omissions in risk factor disclosures. Companies will need to decide whether more or less risk disclosure creates a greater risk of being sued down the road.

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Automotive

Northern District of Ohio Grants Motion To Dismiss Securities Class Action Against Officers of Electric Vehicle Manufacturing Company

Lim v. Hightower (N.D. Ohio Sept. 30, 2024)

What To Know: The Northern District of Ohio dismissed a securities class action complaint against executive officers of an electric vehicle manufacturing company, alleging that the defendants misled investors about the state of a failed partnership with an electronics manufacturer.

Judge Benita Y. Pearson of the U.S. District Court for the Northern District of Ohio dismissed a securities class action complaint against executive officers of Lordstown Motors Corp. (LMC), an electric vehicle manufacturing company. The plaintiffs alleged that the defendants misled investors about the state of LMC’s partnership with electronics manufacturer Foxconn by failing to disclose problems in the partnership that led to Foxconn’s repudiation of its agreement with LMC and LMC’s subsequent bankruptcy. The plaintiffs claimed that, by failing to disclose the problems prior to bankruptcy, the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78j(b) and § 78t(a), and Rule 10b-5 of the Securities and Exchange Commission (SEC).

In May 2022, LMC and Foxconn signed a joint venture agreement (JVA) to combine resources and develop the next generation of electric vehicles. After Foxconn allegedly breached the JVA, the companies restructured their agreement, entering instead into a direct investment agreement on November 7, 2022. Between December 2022 and March 2023, LMC completed several manufacturing milestones. Foxconn, however, delayed providing promised funding to LMC and, as a result, suppliers backed out of deals with LMC. In March 2023, LMC’s stock dropped below \$1 per share. On April 21, 2023, Foxconn sent LMC a notice of default and stated the company would terminate the investment agreement if the stock price did not rise in 30 days. LMC publicly reported the termination and, on June 27, 2023, LMC filed for bankruptcy. LMC also filed an adversary complaint against Foxconn alleging a material breach of the investment agreement.

The plaintiffs alleged that between August 4, 2022, and March 6, 2023, the defendants made multiple misleading statements on earnings calls, in press releases, in a presentation and on a Form 8-K regarding Foxconn and LMC’s partnership. The plaintiffs alleged these statements were misleading because they omitted significant problems between the companies and characterized Foxconn and LMC’s relationship as collaborative and thriving, while the defendants privately believed that Foxconn was trying to sabotage their business. The defendants argued that they had no knowledge of the impending failure of the relationship until Foxconn repudiated the agreement, which then caused them to reevaluate Foxconn’s motive.

The court agreed with the defendants and dismissed the complaint. In assessing the sufficiency of the plaintiffs’ claims, the court first agreed to take judicial notice of several public filings evidencing Foxconn’s stated commitment to the partnership and LMC’s public warnings about the uncertainties surrounding it.

Applying the heightened pleading standards required by the Private Securities Litigation Reform Act (PSLRA), the court then examined whether the plaintiffs had pled any actionable material misrepresentations or omissions. The court first found that the majority of alleged misstatements relayed the defendants’ beliefs, goals and hopes for the future and did not contain definite, material information necessary to trigger a duty to disclose.

Second, the court found that the breaches under the abandoned JVA, delays and other minor issues did not render the statements describing the partnership misleading, especially because of the totality of the state of affairs and the public warnings of risk.

Third, the court held that the safe harbor doctrine protected the defendants' forward-looking statements about the partnership because the statements were qualified by cautionary language in LMC's SEC filings.

Fourth, with respect to scienter, the court held that many of the plaintiffs' allegations rested on hindsight following Foxconn's repudiation of the investment agreement and that, "[w]hen viewed holistically, Plaintiffs' allegations fail[ed] to give rise to a strong inference of scienter, especially in light of more compelling opposing inferences."

Finally, the court held that because the plaintiffs' Section 10(b) and Rule 10b-5 claims failed, the plaintiffs' Section 20(a) claim failed, too.

Cybersecurity and Data Privacy

S.D.N.Y. Sustains Fraud Claims Against Software Developer for Misrepresentations on Cybersecurity Practices, Dismisses Post-Attack Disclosure Claims

SEC v. SolarWinds Corp. (S.D.N.Y. July 18, 2024)

What To Know: The Southern District of New York denied, in part, the defendants' motion to dismiss fraud claims where marketing materials touted cybersecurity practices while company leaders knew of porous systems and hacking vulnerabilities. Separately, the court dismissed the SEC's novel application of Section 13(b)(2) to hacking events, holding that 13(b)(2) applies only to financial accounting internal controls and *not* to cybersecurity.

Judge Paul A. Engelmayer of the U.S. District Court for the Southern District of New York partially denied the software company SolarWinds Corp. and Timothy Brown's motion to dismiss fraud claims related to marketing materials that promoted cybersecurity practices, despite company leaders being aware of security weaknesses and hacking risks. Separately, the court dismissed the SEC's novel application of Section 13(b)(2) to hacking events, ruling that this section pertains only to financial accounting internal controls, not cybersecurity.

SolarWinds designs and sells software that allows IT professionals to manage networks, and Mr. Brown served as the company's vice president of security and architecture. Based on investigative discovery, the SEC alleged that in 2017, Mr. Brown conducted security audits revealing poor cybersecurity practices and presented these vulnerabilities to the company. Meanwhile, the company published materials, including a "Security Statement," touting purported cybersecurity strengths in conflict with Mr. Brown's assessments.

In 2019, SolarWinds' flagship product, Orion, was infiltrated by Russian state-sponsored hackers. Thereafter, two of SolarWinds' clients reported malicious activity. SolarWinds

did *not* disclose those events. After a third customer was similarly breached and identified the means of attack, SolarWinds disclosed the Orion vulnerability.

As to fraud claims based on events preceding the attacks, the court sustained the claims, finding that the company's Security Statement made material misrepresentations and that scienter was imputed to the company through Mr. Brown. Because the company promoted its security in blogposts, podcasts and press releases during this period, the court also sustained a theory of scheme liability. The court noted that a private securities claim based on similar allegations was settled by the company for \$26 million. As to statements following the attacks, the court dismissed the SEC's fraud claims that the 8-k disclosures omitted material information, finding that the SEC's theory was based on hindsight.

The court also rejected the SEC's novel application of Section 13(b)(2)'s internal control requirements to cybersecurity. It held that the text of Section 13(b)(2)(B)(iii) covers *accounting* controls relating to financial transactions and *not* cybersecurity controls, which fall "outside the scope" of the statute.

E-Commerce

Tenth Circuit Upholds Dismissal of Securities Claims Against E-Commerce Company Executives in Market Manipulation and Misrepresentation Case

In re Overstock Sec. Litig. (10th Cir. Oct. 15, 2024)

What To Know: The Tenth Circuit affirmed the dismissal of securities claims that a short seller brought against an e-commerce company for alleged false statements and a "short squeeze" market manipulation scheme.

The Tenth Circuit affirmed the district court's grant of the defendants' motion to dismiss claims brought under Section 10(b) and 20(a) of the Exchange Act. The plaintiff, a short seller of Overstock stock, alleged that defendant Overstock and its executives made false and misleading statements by misrepresenting the past and projected performance of Overstock's Retail Division. The plaintiff also claimed that the defendants manipulated the market in a "short squeeze" scheme by announcing an unregistered dividend that inflated the Overstock stock price and forced short sellers to close their positions by buying stock at a loss.

The court affirmed the dismissal of claims based on the allegedly false and misleading statements about Overstock's Retail Division. In the complaint and on appeal, the plaintiff admitted that it purchased Overstock stock to satisfy their own contractual obligations that were triggered by the unregistered dividend, not because of the statements on Overstock's Retail Division. Thus, the court found that the plaintiff failed to plead reliance on the allegedly false and misleading statements.

Next, the court affirmed the dismissal of the market manipulation claim based on the “short squeeze” scheme, holding that an “open-market transaction may qualify as manipulative conduct, but only if accompanied by plausibly alleged deception.” While Overstock’s then-CEO showed manipulative intent – stating publicly that he “designed [the unregistered dividend] carefully” to “put legitimate short sellers in a bind” – Overstock disclosed the unregistered dividend well in advance of the dividend record date. The court reasoned that given the advance disclosure, the market had sufficient information to form judgments about how the dividend would impact the stock price. Unlike other violations of securities laws based on manipulative intent, the court found that the necessary element of secrecy was absent here and that investors were not deceived.

E.D.N.Y. Partially Dismisses Securities Claims Against Online Clothing Rental Company and Underwriters in IPO Misrepresentation Case

Sharma v. Rent the Runway, Inc. (E.D.N.Y. Sept. 25, 2024)

What To Know: The Eastern District of New York granted in part, and dismissed in part, certain securities fraud claims against an online clothing rental company, holding that the defendants’ public statements regarding consumer demand were not actionable.

Judge Orelia E. Merchant of the U.S. District Court for the Eastern District of New York dismissed in part, and granted in part, certain claims brought by a purported class of individuals against an online clothing rental company, certain of its officers and the underwriters involved in connection with the company’s October 2021 initial public offering (IPO) under Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 (Securities Act). The complaint alleged that the defendants made misrepresentations and omissions in its public documents by misleading investors on customer demand metrics and failing to disclose the significant transportation issues that the company was facing.

The plaintiffs alleged that the defendants’ offering document statements violated Item 303 and 105 because the defendants misrepresented the “state of demand for [the online clothing rental company]’s subscription service.” The defendants argued that the statements concerning consumer demand were not actionable because the defendants’ disclosures regarding their historical performance figures were accurate. The court agreed and noted that the defendants’ disclosures of its historical performance data in its public disclosures showed that both revenues and subscriber numbers were trending upward.

The plaintiffs further alleged that the defendants’ failure to disclose that the company was not meeting “internal subscriber enrollment projections” violated Item 303. The court

disagreed, holding that though such information would be of interest to a reasonable investor, under Second Circuit precedent, the “[d]isclosure of an item of information is not required simply because it may be relevant or of interest to a reasonable investor.”

Lastly, the plaintiffs alleged that the defendants failed to disclose the “significant” and “then-existing” material events or uncertainties that the defendants were facing at the time of the IPO. Specifically, the plaintiffs alleged that the statements regarding the defendants’ shipping costs were misleading because of their failure to disclose material uncertainties or significant risks that existed at the time. The court agreed, holding that the increasing shipping costs that prompted the defendants to switch shipping carriers were required to be disclosed. The court further noted that the fact that shipping costs by a shipping vendor used by the defendants doubled for at least 30 days “should have been disclosed to make the statement not material misleading under Section 11.”

Energy

Northern District of California Dismisses Section 10(b) Claims Brought in Wake of Lahaina Fire

Bhargal v. Hawaiian Elec. Indus., Inc. (N.D. Cal. Oct. 15, 2024)

What To Know: The Northern District of California granted a motion to dismiss a putative securities class action alleging violations of Section 10(b) of the Exchange Act in the wake of the Lahaina wildfire that occurred on August 8, 2023, on the island of Maui.

Judge Jacqueline Scott Corley of the U.S. District Court for the Northern District of California granted Hawaiian Electric Industries, Inc.’s (HEI’s) motion to dismiss a putative securities class action alleging Exchange Act violations, finding HEI was not liable. HEI is a publicly traded Hawaii-based corporation whose subsidiaries collectively provide utility services to 95% of Hawaiian residents. One of its subsidiaries is Hawaiian Electric Company, Inc. (HECO). HEI’s stock price declined after the August 8, 2023, wildfire in Lahaina, on the island of Maui. Shortly thereafter, HEI’s shareholders filed a securities class action asserting that HEI and its subsidiaries made statements that misled investors about their fire mitigation efforts between February 2019 and September 2023.

As to the alleged statements made by HECO, the defendants argued that they were not the makers of those statements merely because HEI wholly owned HECO. The district court agreed. Under *Janus Capital Group, Inc. v. First Derivative Traders*, a defendant “must have ‘made’ the material misstatements” to be liable for securities fraud under SEC Rule 10b-5(b), and a statement is “made” by one who has

ultimate authority over the statement, including its content and dissemination. The court in *Bhargal* found that the investors failed to allege any facts showing that HEI “actually participated in and had authority over” statements made by HECO.” Therefore, HEI and its officers could not be held liable for those statements.

The court also rejected the plaintiffs’ allegations that HEI’s public statements were false when made. The court concluded that the “factual allegations Plaintiffs rely on fall short of a plausible inference of falsity.” Some of the challenged statements included opinions, for which the plaintiffs failed “to meet the first hurdle of plausibly alleging subjective falsity.” The court also found allegations of objective falsity inadequate.

Finally, the court held that the plaintiffs failed to plead facts giving rise to a strong inference that HEI and its executives acted with scienter. The plaintiffs’ allegations of an intent to deceive were not “stronger than the competing inference posed by Defendants: ‘that the Lahaina Wildfire happened despite HECO’s best efforts to prevent it and without Defendants trying to hide that risk’ Or even: while HECO’s efforts to mitigate wildfire risk proved insufficient, there was no attempt by Individual Defendants to misrepresent HECO’s efforts.” The court’s conclusion that scienter was inadequately alleged was bolstered by “the lack of alleged motive, which tips the scale in favor of Defendants on scienter.”

Financial Institutions

Second Circuit Vacates Dismissal of Investment Adviser’s Half-Truth Claims, Affirms Dismissal of Pure Omission Claims Under Rule 10b-5

Moab Partners, L.P. v. Macquarie Infra. Corp. (2d Cir. Aug. 19, 2024)

What To Know: On remand, the Second Circuit applied the U.S. Supreme Court’s ruling in *Macquarie Infrastructure Corp. v. Moab Partners, L.P.* to hold that an investment adviser’s Exchange Act claims under Section 10(b) and Rule 10b-5(b) relying on a “pure omission” theory must be dismissed because, as the Supreme Court held, “[p]ure omissions are not actionable under Rule 10b-5(b).”

The Second Circuit considered the U.S. Supreme Court’s decision in *Macquarie* as well as supplemental briefing by the parties to apply the Supreme Court’s ruling to Moab’s claims. The Second Circuit held that the Supreme Court’s ruling did not disturb the Second Circuit’s previous analysis with respect to Moab’s claims under Rule 10b-5(b) pertaining to “half-truths” or under Rules 10b-5(a) and 10b-5(c). Additionally, the parties did not dispute that Moab’s Exchange Act

claims under Section 10(b) and Rule 10b-5(b) relying on a “pure omission” theory should be dismissed based on the Supreme Court’s ruling that “[p]ure omissions are not actionable under Rule 10b-5(b).”

Ultimately, the Second Circuit vacated the district court’s judgment dismissing Moab’s claims under (i) count one as to the claims under Rule 10b-5(b) resting on half-truths, as well as those under Rules 10b-5(a) and 10b-5(c); and (ii) counts two, three, four, five and six. The court affirmed the district court’s judgment dismissing Moab’s count one claims under Rule 10b-5(b) resting on pure omissions.

Financial Services

First Circuit Affirms Summary Judgment and Disgorgement Order Against Investment Advisers for Misrepresentation of ‘Back-Tested’ Strategy

SEC v. Navellier & Assocs. (1st Cir. July 16, 2024)

What To Know: The First Circuit affirmed a district court’s (i) grant of summary judgment to the SEC on the commission’s claims that investment advisers violated the Investment Advisers Act, (ii) order requiring the advisers to disgorge more than \$22 million and (iii) decision not to reduce the amount of the supersedeas bond.

The First Circuit affirmed the U.S. District Court for the District of Massachusetts (i) grant of summary judgment, (ii) order of disgorgement against various investment advisers and (iii) decision not to reduce the supersedeas bond in a case alleging Investment Advisers Act violations. In 2009, investment advisers licensed an investment strategy (the Strategy). The advisers distributed materials to their clients stating that the Strategy was “active,” meaning its performance was based off of “actual performance figures” that “reflect investment decisions [made] at the time of execution.” But the Strategy was “back-tested,” meaning it was “retroactively applied to historical market data” that reflect “hypothetical performance figures and benefit from hindsight.” In 2013, the advisers sold their Strategy business. The SEC alleged that the advisers violated Investment Advisers Act Sections 206(1) and 206(2), which prohibit “employ[ing] any device, scheme, or artifice to defraud any client or prospective client” and “engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”

The First Circuit held that the advisers violated the Investment Advisers Act by making “a material misrepresentation with a culpable mental state.” First, the advisers made misrepresentations by distributing materials wrongly describing the Strategy as “active.” As support, the court cited internal emails stating that the Strategy “smell[ed] like FRAUD.” Second, the statements were material because it was “obviously important to an investor” to know whether a strategy was

back-tested. Further to that finding, the court noted SEC letters warning the advisers about their “failure to adequately disclose performance figures as back-tested.” Third, the advisers acted with the requisite mental states, scienter for Section 206(1) and negligence for Section 206(2). The advisers’ failure to disclose that the Strategy was back-tested was “an extreme departure from the standards of ordinary care,” satisfying both mental states. The First Circuit rejected the advisers’ selective enforcement and “class of one” affirmative defenses.

The First Circuit then affirmed the district court’s disgorgement order. The court explained that “[t]he amount of disgorgement ‘need only be a reasonable approximation of profits casually connected to the violation.’” The advisers’ “causally connected” profits were (i) “the advisory fees [the advisers’] clients paid” for the Strategy and (ii) “the proceeds from” the Strategy business sale. Consistent with recent U.S. Supreme Court precedent, “legitimate expenses” (i.e., “research expenses, other non-marketing expenses, and non-marketing salaries”) were appropriately deducted from the profit amount.

Finally, the First Circuit found that the district court did not abuse its discretion by not reducing the amount of the supersedeas bond.

Life Sciences and Health Care

Court of Chancery Dismisses ‘Hybrid’ *Malone/Caremark* Claims at Pleadings Stage

In re FibroGen, Inc. Derivative Litig. (Del. Ch. Oct. 2, 2024)

What To Know: The Court of Chancery dismissed the stockholder plaintiffs’ “hybrid” *Malone/Caremark* claims under Court of Chancery Rule 23.1, holding that the plaintiffs failed to establish that a majority of the demand board faced a substantial risk of liability.

Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery dismissed stockholder plaintiffs’ claims under Court of Chancery Rule 23.1 against FibroGen, Inc., a biopharmaceutical company developing a drug to treat anemia. After receiving and disclosing negative results from the Federal Drug Administration (FDA), certain FibroGen directors and officers were sued for violations of federal securities laws related to prior positive – and allegedly false – disclosures regarding FibroGen’s FDA approval process. After a motion to dismiss those claims was denied in part and the litigation was settled, the stockholder plaintiffs brought derivative claims against FibroGen’s directors and officers for “hybrid” claims under *Malone* and *Caremark* theories of fiduciary liability. The plaintiffs also asserted related *Brophy* claims.

The court analyzed the plaintiffs’ claims as a hybrid between (i) a *Malone* claim: a claim that “fiduciaries knowingly disseminated materially false information to stockholders”;

and (ii) a *Caremark* “prong two” claim: a claim that fiduciaries “knew of evidence of corporate misconduct – the proverbial ‘red flag’ – yet acted in bad faith by consciously disregarding its duty to address that misconduct.” The court explained the theory behind the alleged hybrid claim: “Management communicated false and misleading statements to investors and the FDA; even if Plaintiffs have not adequately alleged that a majority of the Director Defendants participated in that dissemination knowingly or intentionally, these Director Defendants’ failure to investigate and intervene, in the face of ‘red flags’ indicating management wrongdoing, amounts to bad faith under a *Caremark* analysis.”

The plaintiffs pointed to three types of communications allegedly containing false disclosures: (i) conference calls and press releases, (ii) Form 10-Q statements and (iii) Form 10-K statements. The court found, consistent with the hybrid claim theory, that the plaintiffs failed to sufficiently plead that a majority of the demand board had knowledge of the allegedly false statements when made or that the board disseminated knowingly false information. The court also rejected the plaintiffs’ argument that the information presented to the directors rose to a level of a “red flag” of wrongdoing. Separately, the court held that even if the board had been presented with “red flags,” there was no sufficient allegation of bad faith conduct because “none of the wrongdoing alleged against FibroGen itself caused the FDA’s rejection of [the drug] – that is, a failure of oversight did not lead to a ‘mission critical’ corporate trauma.”

Because the court held that the plaintiffs failed to establish demand futility under *Malone* or *Caremark*, the court also rejected the plaintiffs’ *Brophy* claims.

Northern District of Illinois Grants Motion To Dismiss Pharmaceutical Company Derivative Action

Treppel Family Trust v. Gonzalez (N.D. Ill. Oct. 4, 2024)

What To Know: The Northern District of Illinois granted a motion to dismiss a shareholder derivative action relating to the FDA’s actions evaluating a pharmaceutical drug.

Judge Georgia N. Alexakis of the U.S. District Court for the Northern District of Illinois dismissed a consolidated shareholder derivative action against defendant officers and directors on behalf of AbbVie Inc. The plaintiffs alleged that the defendants breached their fiduciary duties in connection with the company’s marketing of the drug Rinvoq and violated § 14(a) of the Exchange Act by including materially false and misleading statements in a proxy statement. The court held that the plaintiffs failed to allege facts that would support their assertion that making a pre-suit demand upon the AbbVie board would have been futile.

As AbbVie's most profitable drug Humira came close to the expiration of its patent, AbbVie began to focus on other potential sources of revenue. In 2020, AbbVie requested that the FDA approve its drug Rinvoq – a newer anti-inflammatory drug – to treat inflammatory diseases beyond that for which Rinvoq was initially approved. At the same time, the FDA issued safety warnings for a similar drug, Pfizer's Xeljanz, due to the results of a safety test that demonstrated an increased risk of blood clots. Between April and July 2021, the defendants made numerous statements differentiating Rinvoq from Xeljanz and expressing optimism that the FDA would approve Rinvoq for market in the increased disease areas. In June 2021, AbbVie announced that the FDA would not complete its review of Rinvoq for additional conditions in AbbVie's publicly predicted timeline due to the ongoing Xeljanz safety test. Ultimately, however, on September 1, 2021, the FDA announced that as a result of the potential for serious side effects as shown in the Xeljanz trial, it would require updated warnings for both Xeljanz and Rinvoq and limit further approved uses of the drugs.

Following the FDA's announcement, the plaintiffs brought a derivative action asserting that, among other things, the defendants breached their fiduciary duties of oversight by allowing allegedly false and misleading statements about Rinvoq's research and development prospects and expected FDA approval to be made. The plaintiffs alleged that the defendants violated Section 14(a) of the Exchange Act by making false and misleading statements in AbbVie's 2021 proxy statement, which recommended voting for an amended incentive stock program to encourage proper risk oversight and against an independent board chair, citing the company's "other robust corporate governance practices" as a reason. The plaintiffs asserted these statements were misleading because the stock program encouraged the defendants to inflate the stock price by making overly optimistic statements about Rinvoq and because the corporate governance practices did not prevent the defendants' breaches.

The plaintiffs did not make a pre-suit demand on the board before filing the derivative action – instead, they argued that demand was excused as futile because at least half of AbbVie's board members were named as defendants in the lawsuit and faced a substantial likelihood of liability. Following its assessment of the allegations, the court held that the plaintiffs had failed to allege particularized facts supporting a conclusion that at least half of the board faced a substantial likelihood of liability on any of the claims asserted, and thus had not shown demand futility. With respect to the breach of oversight claim, the court based its decision on the fact that the FDA announced the final results of the Xeljanz trial and the effect of those results on Rinvoq more than a month after the last alleged misrepresentation. Because there was no allegation that any of the director defendants had prior knowl-

edge of FDA actions or that anyone otherwise misrepresented internal AbbVie data, the director defendants had no reason to doubt any public statements about Rinvoq.

In evaluating the § 14(a) claim, the court determined that the plaintiffs failed to plead sufficient facts that would allow an inference that anything in the proxy statement was actually false or misleading at the time it was issued – a requisite for liability under § 14(a). The court emphasized that allegations of later misbehavior did not support the conclusion that the statements were false when made, nor had the plaintiffs alleged sufficient facts to support that the statements were actually false as opposed to merely overly optimistic. Because the plaintiffs did not allege facts to support that demand would be futile for any of their claims, the court granted the defendants' motion to dismiss.

Northern District of California Holds Defendants May Introduce Evidence of Truth on Market To Rebut Price Impact at Class Certification Stage

Pardi v. Tricida, Inc. (N.D. Cal. Sept. 27, 2024)

What To Know: The Northern District of California granted investors' motion for class certification after allowing a biopharmaceutical company's CEO to present evidence that the company's disclosure of a drug application's rejection had no revelatory impact on its stock price due to the company's prior disclosures.

Judge Haywood S. Gillam, Jr. of the Northern District of California addressed claims against clinical-stage biopharmaceutical company Tricida and its CEO, centering on allegations that misleading statements about the company's kidney disease drug veverimer inflated the company's stock price.

In August 2019, Tricida submitted a New Drug Application (NDA) to the FDA for veverimer. Between July 2020 and February 2021, Tricida issued press releases disclosing concerns that the FDA had expressed to Tricida about veverimer's demonstrated efficacy, including an August 24, 2020, announcement that the FDA had denied the NDA, and a February 25, 2021, announcement that the FDA had denied appeal.

Stockholders sued Tricida and its CEO, alleging that the CEO knew about specific concerns with veverimer but instead made misleading statements during a May 7, 2020, earnings call, which artificially inflated Tricida's stock. The investors moved for class certification, arguing that they could prove reliance on a classwide basis under the fraud-on-the-market presumption arising out of *Basic, Inc. v. Levinson*. Under *Basic*, reliance is presumed when the alleged misrepresentations were publicly known and material, the stock is traded in an efficient market, and the investor traded the stock between

when the purported misrepresentations were made and when the alleged truth was revealed.

The CEO argued that the *Basic* presumption could not apply to the entire putative class period because four public disclosures between July and October 2020 fully corrected any alleged misrepresentations made during the May 7 call, which, from that point on, disconnected Tricida's stock price from any presumed inflationary effect from those alleged misrepresentations.

Interpreting U.S. Supreme Court precedent, the district court held that the defendant could present this evidence at the class certification stage. It found that courts may examine, at class certification, facts relating to a truth-on-the-market defense involving both whether and when a fully corrective disclosure was made because such a disclosure could rebut *Basic*'s principle that misrepresentations affect stock prices in efficient markets – that is, a misrepresentation cannot impact an efficient market if the related truth is already public. However, because truth-on-the-market evidence overlaps with a misrepresentation's materiality – a merits issue – the district court cabined its findings to class certification. The court found that the CEO's asserted disclosures were not fully corrective of the alleged misrepresentations, so the *Basic* presumption applied to the entire class period.

M&A

Court of Chancery Dismisses Demand Refusal Derivative Case Under Rule 23.1

In re Kraft Heinz Demand Refused Derivative S'holder Litig. (Del. Ch. July 19, 2024)

What To Know: The Court of Chancery dismissed with prejudice a demand-refused stockholder derivative lawsuit, finding the plaintiffs failed to allege particularized facts creating a reasonable doubt that the board investigated and rejected their demands in good faith and with due care.

Vice Chancellor Lori W. Will of the Delaware Court of Chancery dismissed claims by stockholders against Kraft Heinz's board, finding no wrongful refusal of demands related to a stock sale and impairment disclosures. Six months after 3G Capital Inc. sold part of its ownership interest in Kraft Heinz, Kraft Heinz announced a \$15.4 billion impairment charge. Stockholders claimed 3G's stock sale occurred based on material nonpublic information while Kraft Heinz fiduciaries concealed the looming impairment from the market. Stockholders sent litigation demands to Kraft Heinz's board about the stock sale and impairment-related disclosures.

The board formed an administrative working group of two directors to consider the demands. The working group hired independent legal counsel and a forensic accountant

to assist with its investigation. Together, they reviewed more than 150,000 documents, interviewed a dozen people and considered a detailed prior investigation led by outside counsel. After a two-year process, the working group authored a 110-page report. It recommended the demands be rejected, and the full board agreed.

The plaintiff stockholders sued, alleging the board wrongfully refused their demands. The Court of Chancery dismissed the claims under Rule 23.1 for failure to adequately plead that the demands were wrongfully refused.

The court began its analysis by identifying the plaintiffs' "heavy burden" of pleading "particularized facts which, taken as true, raise a reasonable doubt that the refusal was a valid exercise of business judgment." The court recognized that by making the demands, the plaintiffs waived any claim they might have had that the board could not act independently on the demands. The court then rejected the plaintiffs' two-part argument that the working group was structurally and procedurally flawed.

First, the court reviewed the plaintiffs' allegations that the board was required to form a committee of independent directors, not a working group. The court held that the "concededly unconflicted" board was empowered to decide how to investigate the demands as a matter of business judgment and that it was not required to form a "committee." In addition, the court rejected the plaintiffs' argument that one member of the working group was not independent and faced a "substantial likelihood" of liability merely because he signed the Form 10-Ks containing the relevant impairment-related disclosures.

Second, the court reviewed the plaintiffs' critiques about, among other things, the working group's conclusions and its failure to request certain documents and to speak to certain individuals. The court stated that there is no prescribed procedure that a board must follow when responding to a demand, and the working group's determinations regarding whom to interview and which documents to review were discretionary. The plaintiffs' speculation about potentially overlooked information and "mere disagreement" with the working group's conclusions was insufficient to sustain a claim that the board breached its fiduciary duties.

DC Federal District Court Applies Novel Market Efficiency Analysis To Deny Class Certification Involving Claims Under Securities Law

Bratya SPRL v. Bed Bath & Beyond Corp. (D.D.C. Sept. 27, 2024)

What To Know: The federal District Court for the District of Columbia denied class certification for a putative class of investors alleging securities fraud, holding that reli-

ance issues did not predominate across the class because the lead plaintiff did not prove that the stock, which was listed on the Nasdaq, traded in an efficient market during a “short squeeze.”

Judge Trevor N. McFadden of the U.S. District Court for the District of Columbia denied class certification in a lawsuit against defendant investor Ryan Cohen and his investment firm RC Ventures. A plaintiff investor alleged that in March 2022, Mr. Cohen and RC Ventures bought a nearly 10% stake in Bed Bath & Beyond (BBBY), creating buzz in the meme stock community. That summer, amid a “short squeeze” of BBBY, Mr. Cohen tweeted a “to the moon” emoji responding to a negative BBBY article. However, within a week, Mr. Cohen sold his entire stake in BBBY and its price collapsed. The plaintiff filed suit against Mr. Cohen, RC Ventures and others, seeking to represent a class of investors who bought BBBY stock and suffered losses when the stock price collapsed.

In opposing class certification, Mr. Cohen argued that the putative class could not prove that it relied on his tweeted emoji and SEC filings relating to his holdings because BBBY did not trade in an efficient market during the class period. The court agreed – citing *Basic, Inc. v. Levinson*, the court explained that reliance can be rebuttably presumed if the plaintiff proves that the stock traded in an efficient market. According to the court, a stock trades in an efficient market if prices respond so quickly to new information that traders cannot make profits on the basis of that information. The court found that while indirect indicators of market efficiency would have been evidence that BBBY operated in an efficient market under normal circumstances, the circumstances surrounding the class period here were not normal.

During the class period, BBBY underwent a “short squeeze” where its price unexpectedly rose. BBBY’s trading volume was also unusually high during this period. The court, therefore, found that “BBBY’s hyperactive trading volume seem[ed] less an indication that traders [were] responding to new value-relevant information than that they [were] reacting to (or participating in) market manipulation.” Per the court, “direct [e]vidence of a cause-and-effect relationship between unexpected news and market price . . . is the critical factor – the *sine qua non* of efficiency.” Even if the putative class could invoke *Basic*, the court found that Mr. Cohen rebutted the presumption of reliance by demonstrating that his statement did not have a statistically significant impact on BBBY’s price. Because there was no evidence of market efficiency, the court held that reliance was not a common element that predominated across the putative class.

Web3 and Digital Assets

Northern District of California Allows Securities Claims Against Digital Asset Trading Platform To Proceed

SEC v. Payward, Inc. (N.D. Cal. Aug. 23, 2024)

What To Know: The Northern District of California denied a digital asset trading platform’s motion to dismiss claims brought by the SEC, holding that the trading platform could be liable under the securities laws for secondary-market transactions of digital assets promoted by third parties when those assets constitute investment contracts.

Judge William H. Orrick of the U.S. District Court for the Northern District of California denied digital asset trading platform Kraken’s motion to dismiss claims brought by the SEC. The commission alleged that Kraken is an unregistered broker-dealer, exchange and clearing agency for digital-asset securities, violating Sections 5, 15(a) and 17A of the Exchange Act. Kraken’s platform allows users to buy and sell digital assets created and promoted by third-party blockchain developers, acting as an intermediary between users. Kraken also can act as a direct counterparty to transactions.

Kraken moved to dismiss the action for failure to state a claim, arguing that third-party digital assets that are sold, exchanged and traded on the Kraken platform cannot constitute investment contracts, and therefore are not securities.

The district court concluded that, as to two particular digital assets sold on Kraken’s trading platform, the SEC stated a plausible claim against Kraken because those assets could constitute investment contracts under the test developed in *Securities & Exchange Commission v. W.J. Howey Co.* Under *Howey*, an investment contract exists when there is (i) an investment of money (ii) in a common enterprise (iii) with an expectation of profits produced by the efforts of others. The court held as a threshold matter that *Howey* applies even to secondary-market transactions of digital assets issued or promoted by third parties. It reasoned that, under prevailing case law, whether a transaction constitutes an investment contract depends on the totality of the circumstances and on the economic reality surrounding the contract, transaction or scheme at issue. Although digital assets *themselves* may not constitute investment contracts, the *circumstances of their sale* can constitute an investment contract if the *Howey* test is met. Here, the court found that the *Howey* elements were sufficiently alleged as to Kraken’s sales of two digital assets because the SEC had alleged that the assets formed the *basis* of investment contracts, such that they met the *Howey* elements. The court left open Kraken’s opportunity to rebut the SEC’s pleadings through discovery.

Committee Reports

Banking Law Committee

The Banking Law Committee focuses on the extensive body of law and regulations that govern banking in New York State, at both the federal and state level. Banks are unique in that they can choose to be chartered under either federal or state law, and their counsel need to be up to speed on developments in both areas. Historically the Committee has had guest speakers from the State's Department of Financial Services as well as the Federal Reserve, FDIC, and Comptroller of the Currency, which charters and regulates national banks, to assist banking lawyers in promoting compliance and good relationships between their clients and the regulators.

The Committee's Chair position is currently vacant. All attorneys who are members of the Business Law Section are eligible to apply; please contact Section Liaison Tara Lana (tlana@nysba.org) if you are interested.

Chair Vacant

Bankruptcy Law Committee

The Bankruptcy Law Committee is preparing to host a series of CLE courses starting in spring 2025. We are working with local bankruptcy bars across New York to improve representation of bankruptcy practitioners from across the state. Our goals and objectives include collecting practitioners' views on the status of Subchapter V of the Bankruptcy Code and whether the debt limit should be increased or stay the same.

George Angelich, Chair

Business Organizations Law Committee

The Business Organizations Law Committee comprises attorneys who advise business organizations – corporations, limited liability companies (LLCs) and partnerships. Its primary mission is assisting its members to stay up to speed on legal and regulatory developments that affect their clients in matters such as business formation and expansion, employment law, licensing and tax considerations. The Committee also works closely with the Legislative Committee to promote business-friendly legislation in New York.

The Committee's Chair position is currently vacant. All attorneys who are members of the Business Law Section are eligible to apply; please contact Section liaison Tara Lana (tlana@nysba.org) if you are interested.

Chair Vacant

Derivatives and Structured Products Law Committee

2024 was an active year for the Derivatives and Structured Products Law Committee. We had monthly CLE lunch meetings where host firms gave presentations on a range of topics relevant to the market. These presentations are always interactive and give our members the opportunity to discuss their views and exchange ideas on the legal landscape for derivatives and structured products. Topics included CFTC enforcement actions, certain tax considerations for derivatives, and regulatory updates and transactional considerations for digital assets.

The Committee's members work for different types of institutions, including banks, hedge funds, law firms, digital asset companies and regulators. The Committee provides an important forum where these varied members of the derivatives and structured products legal community can meet and discuss new products, applicable regulatory changes, proposed rules and cases.

This year we saw an increase in membership and interest in membership. We look forward to remaining active and engaged in 2025.

Ilene Froom, Chair

Energy and Climate Law Committee

The Energy and Climate Law Committee focuses on this developing area of law, with a particular emphasis on how it impacts businesses and their attorneys in New York. More generally, the Committee sponsors CLE programming, holds meetings, and works with the Legislative Affairs Committee on developing a legislative agenda. The Committee's Chair position is currently vacant. All attorneys who are members of the Business Law Section are eligible to apply; please contact Section liaison Tara Lana (tlana@nysba.org) if you are interested.

Chair Vacant

ESG Committee

The ESG Committee held a meeting on June 27, 2024, to discuss global regulatory developments as well as the current work of its members and related challenges. The meeting was held both virtually and in person at the New York office of Paul Weiss.

The ESG Committee was also pleased to join for the first time the official lineup for the New York City Climate Week

with a webinar on Critical Actions for Sustainable Global Supply Chains, which was held on September 26, 2024. The ESG Committee partnered for this event with the Responsible Contract Project, a non-for-profit supported by Rutgers Law School whose mission is to develop best contract practices for supply chain management. The presenters of the webinars were mostly members of the ESG Committee: Betty Huber, corporate partner and Global ESG chair at Latham Watkins; Ryan Laddey, ESG and corporate compliance counsel at Ralph Lauren; Vlada Gurvich, law fellow at the International Senior Lawyers Project, and Ben Rutledge from the Responsible Contract Project. The event was moderated by Gal Shargil Yaari from the Arison ESG Center of Reichman University.

The term of the co-chairs of the subcommittee will be ending in 2025 and the committee will be transitioning to new leadership. If you would like to apply, please contact Linda Klefodimou Smith at Linda.klefodimou@nuveen.com or David Curran at dcurran@paulweiss.com.

Linda K. Smith, Co-Chair

Franchise, Distribution and Licensing Law Committee

At the Franchise, Distribution and Licensing Law Committee meeting on July 25, 2024, our guest speaker, Mark Seibert, a franchise consultant and founder of iFranchise Group, gave an insightful presentation on recent trends in franchising. We also discussed the status of NYSBA's proposed amendments to the New York Franchise Sales Act, which originated in the committee. We discussed our meeting earlier in the year between representatives of the franchise committee and the attorney general's office. More recently this fall, NYSBA's Government Relations Department has been continuing to reach out to the state attorney general's office to try to win their support for the proposed amendments.

David Azrin, Chair

Insurance Law Committee

The Insurance Law Committee has been closely following recent proposed changes to the U.S. insurance regulatory regime and is currently in the process of planning panel discussions for early 2025 regarding recent changes to the regulatory regimes governing investments by insurers, inter-affiliate transactions and the increasing involvement by private equity actors in the insurance industry.

Sanjiv Tata, Chair

Legislative Affairs Committee

After a hectic 2024, the 2025 legislative session (which officially ends June 30, 2025) was quieter for business law purposes. The Legislative Committee, with the support of the NYSBA Governmental Relations Department, continued to monitor bills and legislative proposals at the state and federal levels. The committee also liaised with other committees in addressing lobbying issues, including outreach by our Franchise Law Committee to the attorney general regarding potential changes to franchise regulation. We always welcome participation in legislative affairs by all section members.

Michael A. de Freitas, Chair

Membership and Diversity Committee

Advancing the goals of diversity, equity and inclusion (DEI) has become more challenging for corporations and law firms in the last few years. In light of these challenges, the Business Law Section's Spring Meeting offered CLE programs focused on helping section members to identify the areas businesses should prioritize to continue to advance their goals of DEI. Attendees were able to receive CLE credits in Ethics, Diversity, Inclusion & Elimination of Bias, and Cybersecurity.

The Business Law Section also has established an annual fellowship program that connects law students with section members seeking a summer job.

"Interns are like not-cut diamonds. They have flaws . . . but once you cut them well, they can become something great one day. And that's what I'm doing, I'm cutting diamonds . . ."
(Anonymous)

Summer internships are an invaluable experience for law students. Many or most lawyers had a summer job that helped to shape our future careers. The job helped us (1) know we wanted to be a lawyer, (2) figure out which area of law excited us and/or (3) connect us to a mentor. Internships also can serve as a pipeline of talent for an employer, a practice area and NYSBA. The program is administered by the newly combined Membership and Diversity Committee. On the inside front cover of this issue you will find more details about the program and instructions on how to participate. In addition to our annual Fellowship Program, the Committee launched its other pipeline program – a mentoring program in December. The Committee is also planning a membership mixer at the January 2025 Annual Meeting. Please look for an invite to the mixer in early January.

Taa Grays and Jessica Thaler, Co-Chairs

Mergers and Acquisitions Committee

The M&A Committee is pleased to report that it participated in the Business Law Section's fall 2024 meeting this past November with a fascinating panel, "The Practitioners' Guide to Navigating the Negotiation of Growth Equity Transactions." Panelists included attorneys from Finn Dixon & Herling LLP, Bowery Legal, and Avorn Law. The Committee is actively planning its upcoming panel to take place live and in person at the 2025 Annual Meeting at the New York Hilton in January, which will provide an outlook on the M&A and Private Equity deal market for the coming year.

David Lallouz, Chair

Not-For-Profit Corporations Law Committee

The Not-for-Profit Corporations Law Committee is working to schedule a meeting in early 2025 to discuss the incoming administration and what impact it may have on nonprofit organizations, including any potential issues that may conflict with New York State laws.

Anita Pelletier, Chair

Private Fund Committee

The Private Fund Committee sponsored a program on "Cayman Islands Recent Regulatory Issues and Updates for Private Funds" on May 22, 2024. The speakers were Chris Humphreys and Megan Wright of Stuarts Humphreys. The Committee co-sponsored a program on May 22, 2024, "Key EU Developments for U.S. Asset Managers." The speakers gave an overview of these developments through the lens of the Irish and Luxembourg regulators. They also addressed, among other issues, the Funds Name Rule; an update from Brussels on the progress of the SFDR consultation launched by the EU Commissions as well as an overview of the recent wave of ESG-focused asset management regulatory exams. Speakers included Antoine Peter from Arendt and David Walsh and was moderated by Linda Klefodimou Smith of Nuveen/TIAA.

The Committee co-sponsored a program on cybersecurity implications on June 12, 2024. This program addressed new regulations and reporting requirements relating to procedures maintained by publicly reporting companies to prevent cybersecurity incidents and the occurrence of cybersecurity incidents. Discussion included a look at the new 8-K and 10-K reporting requirements as well as other new regulatory matters. The speakers included Mary Hildebrand of Lowenstein Sandler.

On September 18, 2024 the Committee held a program called "Regulation S-P Amendments: Privacy of Consumer Financial Information and Safeguarding Customer Infor-

mation." This program covered the Securities and Exchange Commission's amendments to Regulation S-P, with a particular focus on its impact for registered investment advisers. These changes mark a pivotal shift in the financial industry's approach to data security and privacy and include: new notification requirements; incident response programs; expanded safeguard and disposal rules; as well as changes to the privacy notice. The speakers were James Leahy and Danielle Tuluca from Florio Leahy LLP.

On November 13, 2024 the Committee sponsored "New FinCEN Anti-Money Laundering Rules for Investment Advisers" This session explored the U.S. Treasury Department's long-awaited regulations that – once effective in January 2026 – will subject most investment advisers to comprehensive anti-money laundering regulatory requirements. The speaker was Greg Seidner of Skadden, Arps, Slate, Meagher & Flom LLP.

The Committee will be holding its first 2025 program, a Securities Litigation Update, on January 15. Shaud Tavakoli from Skadden's Complex Litigation and Trials Department will examine recent developments in major securities-related cases over the past year.

Anastasia Rockas, Chair

Securities Regulation Committee

The Securities Regulation Committee was a co-sponsor, with the Private Fund Committee, of a presentation entitled "The New FinCEN Anti-Money Laundering Rules Applicable to Investment Advisers" at the Business Law Section fall meeting. The presentation featured Greg Seidner, an associate in the London office of Skadden Arps, and was organized by Committee member and Private Fund Chair Anastasia Rockas, a partner at Skadden in New York.

The Committee remains committed to bringing back regular in-person meetings, which were held regularly prior to COVID. We are actively seeking topics of broad public interest and are working toward an in-person meeting in January or February.

Joseph Danowsky, Chair

Technology and Venture Law Committee

The Technology and Venture Law Committee continues its focus on educating those involved in the new technology sector with a focus on artificial intelligence, privacy, cybersecurity, and their effect on the legal profession.

The 2024 spring meeting focused on privacy and cybersecurity. The U.S. currently presents a kaleidoscopic or fragmented (rather than comprehensive) system of federal and state laws and regulations, and common law principles that

regulate privacy. Privacy laws regulate the collection, use, processing, disclosure, and security of personal information. Cybersecurity is the art of protecting networks, devices, and data from unauthorized access or criminal use and the practice of ensuring confidentiality, integrity, and availability of information. The CLE focused also on generative AI, i.e. a machine-learning model that is trained to create new data, rather than making a prediction about a specific dataset. A GenAI system is one that learns to generate more objects that look like the data it was trained on. GenAI creates a new work that is similar (in terms of text, video, images) but not identical to the original input data. GenAI uses techniques like “deep learning” and is the tool attorneys use to conduct research, drafting text and for other legal purposes, like e-discovery. The risks for attorneys (and non-attorneys engaged in legal activities) using GenAI include plagiarism, violation of privacy, unauthorized practice of law, professional malpractice, copyright infringement, and bias, just to name a few.

In April the Committee offered another CLE reflecting on AI in the context of the legal profession. Doubts have been raised on the usefulness of UBE percentile as a proxy for lawyerly competence (both for humans and AI systems), given that, for example: (a) the content on the UBE is very general and does not pertain to the legal doctrine of any jurisdiction in the United States and thus knowledge (or ignorance) of that content does not necessarily translate to knowledge (or ignorance) of relevant legal doctrine for a practicing lawyer of any jurisdiction; (b) the tasks involved on the bar exam, particularly multiple-choice questions, do not reflect the tasks of practicing lawyers, and thus mastery (or lack of mastery) of those tasks does not necessarily reflect mastery (or lack of mastery) of the tasks of practicing lawyers. The CLE showed that GPT-4 (Generative Pre-trained Transformer) is substantially less lawyerly competent than previously assumed, as GPT-4’s score against likely attorneys (i.e., those who actually passed the bar) is ~48th percentile. When just looking at the essays, GPT-4’s performance falls in the bottom ~15th percentile.

For the BLS Fall Meeting, the Committee co-organized another CLE program with the M&A Committee. The Technology and Venture Law session was dedicated to the intersection between M&A (mergers & acquisitions) and VC (venture capital), with a discussion on the VC perspectives.

Luca Melchionna, Chair

Wine, Beer and Spirits Law Committee

The Committee continues to monitor legal issues and developments related to interstate shipping of wine, beer and spirits and the importation of alcoholic beverages from foreign countries, especially in light of the incoming administration. While many consider the “trade wars” to be on “pause” and not over, threats of tariffs similar to 2018 and the resulting damage to the domestic whiskey industry and U.S.-based wine importers continue to concern industry stakeholders. Can the industry survive Trade Wars 2.0? We continue to analyze market data, discuss with stakeholders and policy makers, advise clients, and attempt to answer the age-old question, are tariffs simply a tax on the consumer?

The Committee notes the governor’s attempt to modernize the state’s Alcohol Beverage Control (ABC) Law, resulting in the expansion of licensing options, streamlining of the application process, extension of “to-go” alcohol sales, and one-day events permits. These changes have resulted in a more vibrant and profitable environment for the sales of alcoholic beverages, which has also translated into more business transactions that have required our input on legal issues. However, it must be balanced with complaints of U.S. wine market saturation and shrinking distribution channels.

The Committee held a continuing legal education seminar on the proposition of new tariffs in the past, and anticipates offering an updated presentation on the potential for collateral damage on the industry. Additional programming on the reality of shifting domestic purchasing demographics and distribution concerns, with appropriate wine, beer and spirits accompaniments, are planned for later in 2025.

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Student Writing Competition

The Business Law Section sponsors an annual Student Writing Competition, open to all students who are candidates for the J.D. or LL.M. degree at an accredited law school during the year in which the article is submitted.

Articles submitted in a given year that are judged first, second and third best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of \$2,000, \$1,500 and \$1,000, respectively.

At the discretion of the editors, they also will be published in the NY Business Law Journal, which is sponsored by the Section in cooperation with Albany Law School.

Additional cash prizes may be awarded at the discretion of the Section. Entries that do not qualify for cash prizes may also be considered for publication in the Journal.

Articles submitted will be judged on the following criteria: relevance to the Journal's audience (New York business lawyers); timeliness of the topic; originality; quality of research and writing; and clarity and conciseness.

The manuscript should follow *Bluebook* cite format (using endnotes rather than footnotes) and be a minimum of 3,000 words (there is no maximum). All submissions become the property of NYSBA and the NY Business Law Journal. By submitting an article, the student is deemed to consent to its publication, whether or not a cash prize is awarded. To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA NY Business Law Journal (davidlglass@me.com). The student should include a brief biography, including law school attended, degree for which the student is a candidate, and expected year of graduation.

The Editors congratulate the winners of the 2024 Competition:

FIRST PRIZE (\$2,500)

Taryn Willett, University of Texas Law School: "On the Constitutionality of New York's Marihuana Regulation and Taxation Act: An Analysis of New York's True Party of Interest Framework Under the Dormant Commerce Clause" (NY Business Law Journal, 28, no.1, Summer 2024)

SECOND PRIZE (\$1,500)

Julia Vavrinec, Albany Law School: "Restoring Trust: The Role of the Cryptocurrency Accountability Act in Government Transparency," (NY Business Law Journal 28, no. 2, Winter 2024)

THIRD PRIZE (\$1,000)

Elijah Sullivan, Albany Law School: "Leveraging Refundable Tax Credits for a Universal Basic Income" (NY Business Law Journal 28, no. 1, Summer 2024)



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