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THE CLOCK IS TICKING! THE TYPES OF CYBERSECURITY DISCLOSURES REQUIRED BY THE SECURITIES AND EXCHANGE COMMISSION

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On February 21, the Securities and Exchange Commission (SEC) "voted unanimously to approve a statement and interpretive guidance to assist public companies in preparing disclosures about cybersecurity risks and incidents."[1] The SEC did not wait long for the public to absorb this guidance.

On April 24, the SEC "announced that the entity formerly known as Yahoo! Inc. has agreed to pay a $35 million penalty to settle charges that it misled investors by failing to disclose one of the world's largest data breaches in which hackers stole personal data relating to hundreds of millions of user accounts."[2] In the space of two months, the SEC went from "companies also may have disclosure obligations" for breaches to levying a penalty of $35 million for failure to disclose.[3] When the expectations change so quickly, it is important for companies to think strategically not only about where enforcement action has been but also where it is going.

It is now clear that the SEC is operating in the cyber-enforcement space and that they expect fast answers. What, however, do they want?

Overview of the "Commission Statement and Guidance on Public Company Cybersecurity Disclosures"

The thesis statement for the SEC's guidance occurs on the first page: "Cybersecu-

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rity risks pose grave threats to investors, our capital markets, and our country." According to the SEC, secure networks and technology are "analogous to the importance of electricity and other forms of power in the past century."[4] Adequate security is therefore critical.

The SEC then takes the time to articulate that companies that fail to have adequate cybersecurity may suffer "substantial costs" and "negative consequences."[5] These costs include: the costs of remediation; the costs of making changes to controls and procedures; and the cost of regulatory actions.[6] While the SEC does not set forth specific procedures, it expressly states that issuers must have established "disclosure controls and procedures that provide an appropriate method of discerning the impact that such matters may have on the company and its business, financial condition, and results of operations, as well as a protocol to determine the potential materiality of such risks and incidents."[7] These controls and procedures for cyber risk must be certified and disclosed in the company's regular financial statements.[8]

Cyber Risk Controls and Procedures

The responsibility for developing cyber risk controls and procedures is squarely upon the company's directors and officers.[9] While these disclosures need not be detailed, they must be made within the existing framework for reporting any other material event.[10] Accordingly, the same Exchange Act Rules 13a-15 and 15d-15 require disclosure of controls and procedures, tested by company management, for cyber risks.

The materiality of cyber risks or incidents depends on the importance of the information in question. The range of harm from the loss of control over the information is driven by potential damage to: the company's reputation, financial performance; customer and vendor relationships; and the possibility of litigation or regulatory investigations or actions.[11]

In disclosing these risks, the Commission states that companies should describe management's controls and procedures, not the technical details of the company's networks. These controls

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and procedures should focus on how issues are communicated to the board.

While the details of these controls and procedures are left unsaid by the SEC, they do state that the disclosure should be tailored to the specific company, industry, risks, and incidents[12]—generic, catch-all disclosures will not be sufficient.

Breach Disclosures Must Be Made on a Rolling Basis

The Commission stated it expects that both internal and external (law enforcement) investigations may affect the ability to fully disclose the breach.[13] However, the SEC envisions quarterly corrective disclosures in lock step with those investigations.[14]

Corporate boards and directors are admonished that they "should also ensure timely collection and evaluation of information potentially subject to required disclosure, or relevant to an assessment of the need to disclose developments and risks that pertain to the company's businesses."[15]

The Message: The Clock is Ticking

In light of the Yahoo! settlement, corporate boards and directors should adhere to a quarterly update schedule for the disclosure of material cyber risks. In anticipation of each quarterly filing, the controls and procedures of the company should encourage a searching cyber-materiality analysis.

Even if the risks have already been disclosed, the company's analysis should include an examination of supplemental, clarifying disclosures. More information about the SEC's approach will likely come soon. For now, any emerging cyber risk is on a three-month clock.

ENDNOTES:

[1]*See* "Commission Statement and Guidance on Public Company Cybersecurity Disclosures"; U.S. Securities and Exchange Commission, 17 CFR Parts 229 and 249 [Release Nos. 33-10459; 34-82746]; *available at* https://www.sec.gov/rules/interp/2018/33-10459.pdf.

[2]*See* https://www.sec.gov/news/press-release/2018-71.

[3]*See* https://www.sec.gov/rules/interp/2018/33-10459.pdf; *see also* 17 CFR 243.100. Final Rule: Selective Disclosure and Insider Trading, Release No. 34-43154 (Aug. 15, 2000) [65 FR 51716 (Aug. 24, 2000)].

[4]"Commission Statement and Guidance on Public Company Cybersecurity Disclosures" at 2.

[5]*Id.* at 3.

[6]*Id.* at 3-4.

[7]*Id.* at 4.

[8]*See* CF Disclosure Guidance: Topic No. 2-Cybersecurity (Oct. 13, 2011), *available at* https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm; *see also* 8 Final Rule: Proxy Disclosure Enhancements, Release No. 33-9089 (Dec. 16, 2009) [74 FR 68334 (Dec. 23, 2009)], *available at* http://www.sec.gov/rules/final/2009/33-9089.pdf.

[9]"Commission Statement and Guidance on Public Company Cybersecurity Disclosures" at 5.

[10]*Id.* at 11.

[11]*Id.* at 11.

[12]*Id.* at 12.

[13]*Id.* at 12.

[14] *Id.* at 12 n. 37.

[15] *Id.* at 18.

SEN. WARREN INTRODUCES "ACCOUNTABLE CAPITALISM ACT" TO ELIMINATE SKEWED MARKET INCENTIVES

From the Office of Sen. Elizabeth Warren

In a press release, United States Senator Elizabeth Warren (D-Mass.) announced on August 15 the introduction of the "Accountable Capitalism Act" which she said would return the country's financial system "to the era when American corporations and American workers did well together." The full text of her bill can be found here: https://www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act.pdf.

U.S. Senator Elizabeth Warren (D-Mass.) today introduced the Accountable Capitalism Act[1] to help eliminate skewed market incentives and return to the era when American corporations and American workers did well together. The legislation aims to reverse the harmful trends over the last 30 years that have led to record corporate profits and rising worker productivity but stagnant wages.

For most of our country's history, American corporations balanced their responsibilities to all of their stakeholders—employees, shareholders, communities—in corporate decisions. It worked: profits went up, productivity went up, wages went up, and America built a thriving middle class.

But in the 1980s a new idea quickly took hold: American corporations should focus only on maximizing returns to their shareholders. That had a seismic impact on the American economy. In the early 1980s, America's biggest companies dedicated less than half of their profits to shareholders and reinvested the rest in the company. But over the last decade, big American companies have dedicated 93% of earnings to shareholders—redirecting trillions of dollars that could have gone to workers or long-term investments. The result is that booming corporate profits and rising worker productivity have not led to rising wages.

Additionally, because the wealthiest top 10% of American households own 84% of all American-held shares—while more than 50% of American households own no stock at all—the dedication to "maximizing shareholder value" means that the multi-trillion dollar American corporate system is focused explicitly on making the richest Americans even richer.

"There's a fundamental problem with our economy. For decades, American workers have helped create record corporate profits but have seen their wages hardly budge. To fix this problem we need to end the harmful corporate obsession with maximizing shareholder returns at all costs, which has sucked trillions of dollars away from workers and necessary long-term investments," said Sen. Warren. "My bill will help the American economy return to the era when American companies and American workers did well together."

Since the passage of the Republican tax bill, American companies have already announced more than half a trillion dollars in stock buybacks this year while real wages remain flat. There is an urgent need to end the grip of shareholder-value maximization and return to the era when American corporations produced broad-based growth that helped workers and shareholders alike.

The Accountable Capitalism Act:

- **Requires very large American corporations to obtain a federal charter as a "United States corporation," which obligates company directors to consider the interests of all corporate stakeholders—**American corporations with more than $1 billion in annual revenue must obtain a federal charter from a newly formed Office of United States Corporations within the Department of Commerce. The new federal charter obligates company directors to consider the interests of all corporate stakeholders—including employees, customers, shareholders, and the communities in which the company operates. This approach is derived from the thriving benefit corporation model[2] that 33 states and the District of Columbia have adopted and that companies like Patagonia, Danone North America, and Kickstarter have embraced with strong results.

- **Empowers workers at United States corporations to elect at least 40% of Board members—**Borrowing from the successful approach in Germany and other developed economies, a United States corporation must ensure that no fewer than 40% of its directors are selected by the corporation's employees.

- **Restricts the sales of company shares by the directors and officers of United States corporations—**Top corporate executives are now compensated mostly in company equity,[3] which gives them huge financial incentives to focus exclusively on shareholder returns. To ensure that they are focused on the long-term interests of all corporate stakeholders, the bill prohibits directors and officers of United States corporations from selling company shares within five years of receiving them or within three years of a company stock buyback.

- **Prohibits United States corporations from making any political expenditures without the approval of 75% of its directors and shareholders—**Drawing on a proposal from John Bogle,[4] the founder of the investment company Vanguard, United States corporations must receive the approval of at least 75% of their shareholders and 75% of their directors before engaging in political expenditures. This ensures any political expenditures benefit all corporate stakeholders.

- **Permits the federal government to revoke the charter of a United States corporation if the company has engaged in repeated and egregious illegal conduct—**State Attorneys General are authorized to submit petitions to the Office of United States Corporations to revoke a United States corporation's charter. If the Director of the Office finds that the corporation has a history of egregious and repeated illegal conduct and has failed to take meaningful steps to address its problems, she may grant the petition. The company's charter would then be revoked a year later—giving the company time before its charter is revoked to make the case to Congress that it should retain its charter in the same or in a modified form.

One-page Summary: The Accountable Capitalism Act

For much of their history, American corporations tried to balance the interests of all of their stakeholders, including employees, customers, business partners, and shareholders. But in the 1980s, corporations adopted the belief that their only legitimate and legal purpose was "maximizing shareholder value." By 1997, the Business Roundtable declared that the "principal objective of a business enterprise is to generate economic returns to its owners."

This shift is a root cause of many of America's fundamental economic problems. In the early 1980s, America's biggest companies dedicated less than half of their profits to shareholders and reinvested the rest in the company. But over the last decade, big American companies have dedicated 93% of their earnings to shareholders.[5]

That has redirected trillions of dollars[6] that might have otherwise gone to workers or long-term investments, with predictable results. Since the advent of shareholder value maximization, worker productivity has risen steadily but real wages for the median worker have been basically flat[7] and the share of national income that goes to workers has dropped markedly.[8] Big American companies have chronically under-invested,[9] opening the door to foreign competitors.

ENDNOTES:

[1]*See* the Accountable Capitalism Act; *available at* https://www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act.pdf.

[2]*See* Benefit Corporation Legislation tracker at http://benefitcorp.net/policymakers/state-by-state-status.

[3]Nitzan Shilon, "Replacing Executive Equity Compensation: The Case for Cash for Long-Term Performance"; Delaware Journal of Corporate Law (Forthcoming); February 28, 2018; *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3131613.

[4]John Bogle, "The Supreme Court Had Its Say. Now Let Shareholders Decide"; NY Times Op-Ed, May 14, 2011; *available here* (subscription may be required): https://www.nytimes.com/2011/05/15/opinion/15bogle.html.

[5]*See* http://thehill.com/opinion/finance/372760-congress-can-turn-the-republican-tax-cuts-into-new-middle-class-jobs.

[6]*See* https://www.ineteconomics.org/uploads/papers/WP_58-Lazonick-Functions-Fallacies-REVISED-20170720.pdf.

[7]*See* https://www.epi.org/productivity-pay-gap.

[8]*See* https://fred.stlouisfed.org/series/LABSHPUSA156NRUG.

[9]*See* http://www.nber.org/papers/w22897.

CRYPTOCURRENCY OUTLOOK: FOUR KEY INDICATORS IT'S HERE TO STAY (AND MAY BE THE FUTURE OF MONEY!)

By Brian G. Sewell

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The decision on August 6 by the Securities and Exchange Commission (SEC) to postpone a ruling on whether to approve the SolidX Bitcoin Shares Exchange Traded Fund (ETF) for trading on The Chicago Board Options Exchange (CBOE) is a good sign.

Given previous SEC statements, the postponement appears to suggest that the U.S. regulatory agency wants to issue a well-thought-out approval ruling that protects cryptocurrency investors and nurtures innovators. I agree with the CBOE that "investors are better served by products traded on a regulated securities market and protected by robust securities laws." And I would rather see the SEC make a methodical decision to approve a cryptocurrency ETF, with thoughtful guidelines than a rash decision to reject one.

Bitcoin's Challenges and Promise

Since 2010, when it emerged as the first legitimate cryptocurrency, Bitcoin has been declared "dead" by pundits more than 300 times. Critics have cited the cryptocurrency's hair-raising price volatility; its scalability challenges of being able to handle a large volume of transactions as a payment method; or the improbability of a central bank ceding monetary control to a piece of preset software code. Despite this, the adoption of Bitcoin as an alternative to transacting by credit card or other payment methods is rising.[1] After its release as open-source software in 2009, Bitcoin alone has facilitated more than 300 million digital transactions, while hundreds of other cryptocurrencies have emerged, promising to disrupt a host of industries.

Granted, no more than 3.5% of households worldwide have adopted cryptocurrency as a payment method. But as developers and regulators resolve the following key issues, global cryptocurrency adoption will likely grow—both as a consumer payment method and through business-to-business integration, thereby streamlining a variety of operations in the private and public sectors. The prospect of more widespread adoption explains why I think cryptocurrencies may continue to outperform other investment assets in the long term and improve how the world does business.

Four Key Reasons Why Cryptocurrency is Here to Stay

1. An SEC-Approved Bitcoin ETF Can Boost Liquidity, Protect Consumers, and Nurture Innovators

Though the SEC may not reach a final decision until next year on the proposed listing of SolidX Bitcoin Shares ETF, I think the agency will eventually approve what many experts say represents the best proposal for a cryptocurrency ETF. The proposal—which requires a minimum investment of 25 Bitcoins, or US $165,000 (assuming a Bitcoin price of $6,500)—seems to meet the SEC's criteria on valuation, liquidity, fraud protection/custody, and potential manipulation.

By boosting institutional investment, SEC approval would represent another milestone in the validation of cryptocurrencies. To reiterate, rising adoption could benefit the U.S. financial system and other financial systems worldwide, because cryptocurrency promises to create significant financial savings and societal benefits by streamlining how the world transacts for goods and services, updates mutual ledgers, executes contracts, and accesses records.

2. Comprehensive U.S. Regulation Can Improve Protection, Innovation, and Investment

Beyond a potential Bitcoin ETF, demand is mounting for a comprehensive regulatory framework that protects consumers while nurturing innovation. Because the dollar remains the leading global fiat currency, institutional investors across the globe are especially watching for what framework of rules and policing *U.S.* regulators develop.

Although many institutional investors are assessing the risk/reward proposition of cryptocurrency investments, that doesn't mean they're ready to invest. Many such endowments, pension funds, and corporate investors are awaiting U.S. regulatory guidance and protections to honor their fiduciary duties. How, if at all, for example, will exchanges be required to implement systems and procedures to prevent hacks and otherwise protect or compensate investors from cyber-attacks?

Though there's mounting pressure on regulators to act, cryptocurrency regulation that both protects consumers and nurtures innovation requires a nuanced set of rules, a sophisticated arsenal of policing tools, sound protocols, and well-trained professionals. Developing such a unique strategy takes time and may involve some stumbles. But I think U.S. regulators will eventually succeed in developing a comprehensive and balanced regulatory framework for cryptocurrency.

If institutions become more confident that regulations can help them meet their fiduciary duties, even small allocations from reputable endowments, pensions, and corporations could unleash a new wave of investment in cryptocurrencies.

3. Bringing the Technology to Scale

Bitcoin and other cryptocurrencies are still developing the capacity to function at a mass scale, which will require processing tens of thousands of transactions per second. But technology such as Plasma, built on Ethereum, and the Lightning Network, a second-layer payment protocol compatible with Bitcoin, are being tested. Indeed, these new technologies could enable cryptocurrencies to execute faster, cheaper payments and settlements than any other payment method. Though developing applications that bring cryptocurrencies such as Bitcoin and Ethereum to scale may not happen overnight, I think sooner or later, developers will get it right.

Making cryptocurrency scalable would probably unleash an explosion of new applications. That would boost adoption by allowing consumers and businesses to more easily take advantage of cryptocurrency by seamlessly integrating it with debit and credit payment systems—again, to execute transactions, initiate contracts, update mutual ledgers, and access records.

Such financial activities would likely happen more quickly, cheaply, and efficiently than ever because there would be no banking intermediary needed to validate the transaction and take a cut of the fees. This could improve the cost and efficiency of commerce—between businesses, between businesses and consumers, between governments and consumers, between nonprofits and consumers, and in every combination thereof. The seeds for this transformation of commerce have been planted, and like the internet before it, can innovate in ways we can't fully anticipate.

4. Meeting Developing World Needs

At its current technological stage, use of cryptocurrency adoption as a payment method could grow fastest in emerging markets, especially those without a secure, reliable banking infrastructure. Many consumers in such regions have a strong incentive to transact in cryptocurrency—either because their country's current banking payment system is inefficient and unreliable, or they lack a bank account altogether. Globally, 1.7 billion adults remain unbanked; and two-thirds of them own a mobile phone that could help them use cryptocurrency to transact and access other blockchain-based financial services.[2]

Data underscores the receptiveness of Developing World consumers to cryptocurrency as a transaction medium. The Asia Pacific region has the highest proportion of global users of cryptocurrency as a transaction medium (38%), followed by Europe (27%), North America (17%), Latin America (14%), and Africa/The Middle East (4%), according to a University of Cambridge estimate.[3] Although the study's authors caution that their figures may underestimate North American's proportion of global cryptocurrency usage, they cite additional data from LocalBitcoin, a P2P exchange platform, suggesting that cryptocurrency transaction volume is particularly growing in developing regions, especially in:

- Asia (China, India, Malaysia, Thailand);
- Latin America (Brazil, Chile, Colombia, Mexico, Venezuela);
- Africa/The Middle East (Kenya, Saudi Arabia, Tanzania, Turkey); and
- Eastern Europe (Russia, Ukraine).[4]

As more applications launch in the developing world to facilitate the use of cryptocurrencies to buy and sell goods and services at lower cost and in expanded markets—and as more young people who are receptive to such new technologies come of age—cryptocurrency adoption could well rise exponentially.

Remember the Internet: Investment Bubbles and Bursts Will Identify the Winners

High volatility is inherent in the investment value of this nascent technology, due to factors including technological setbacks and breakthroughs, the impact of pundits, the uneven pace of adoption, and regulatory uncertainty. Bitcoin, for example, generated a four-year annualized return as of January 31, 2018 up 393.8%, a one-year 2017 performance up 1,318%—and year-to-date, down 52.1%. Bitcoin has experienced even larger percentage drops in the past, before resuming an upward trajectory.

I believe roughly 30% of Bitcoin investors over the past half-year are speculators because the cryptocurrency has dropped on negative news by as much as one-third. In my view, Bitcoin and other cryptocurrencies will experience many more bubbles and bursts, in part, fueled by speculators who buy on greed and sell on fear.

As the previous dot-com era underscored, however, the bursting of an investment bubble may signal both a crash and the dawn of a new era. While irrational investments in internet technology in the 1990s fueled the dot-com bust, some well-run companies survived and led the next phase of the internet revolution. Similarly, despite periodic price crashes, I believe a small group of cryptocurrencies and other blockchain applications, including Bitcoin, will become integrated into our daily lives, both behind the scenes and in daily commerce.

Although "irrational exuberance" will continue to impact the price of cryptocurrencies, this disruptive technology represents the future not only of money but of how the world will do business.

Appendix A: Details on the Proposed SolidX Bitcoin Shares ETF

The proposal seeks to list and trade shares of SolidX Bitcoin Shares; an ETF issued by the VanEck SolidX Bitcoin Trust, on the CBOE, specifically the CBOE BZX Equities Exchange.

Shares—The fund will be backed by actual Bitcoins. Each share will equal 25 Bitcoins, which totals US $165,000, assuming a Bitcoin price of $6,500.

The SEC could approve or reject the proposed fund by the end of September, or the SEC could postpone a decision by as much as 240 days from its July 2 posting, which would mean by March 4, 2019 at the latest.

Security—The ETF Bitcoins holdings would be insured to protect shareholders from exchange hacks and other fraudulent activity. And the CBOE is a well-established, recognized and regulated exchange, the first to be approved to list Bitcoin futures.

The Issuer—VanEck is an award-winning investment and money manager, which operates more than 70 ETFs and ETPs. SolidX brings expertise in blockchain and Bitcoin capital markets, consulting services, and software development.

On July 20, VanEck and SolidX wrote a letter to the SEC outlining how it had addressed the agency's concerns.[5]

Appendix B: The Fundamentals—What Cryptocurrency Has Going For it

The Value Proposition—While the internet enabled the peer-to-peer exchange of digital *communications*, blockchain technology enables the peer-to-peer exchange of *value*, without needing a trusted third party to authenticate transactions. Blockchain technology instead provides a system of trust vested in a process: open source software, a digital peer-to-peer transfer system, checks and balances, math-based incentives, software encryption, and an online chain of public transaction records.

Blockchain technology thus promises a myriad of applications to instantaneously transact, initiate contracts, update ledgers, or share databases, in a way that's faster and cheaper than current alternatives.

Bitcoin represents the first blockchain application and the first cryptocurrency, promising secure, efficient digital payments. At its current stage, Bitcoin has particular appeal in emerging economies that lack a secure, robust system for financial payments. Both digital payments and cryptocurrency represent only one of the countless potential applications of blockchain technology.

As Bitcoin and other cryptocurrencies evolve to achieve the "scalability" to process tens of thousands or more transactions per second, more applications will likely proliferate that integrate Bitcoin and other cryptocurrencies, notably in the rapidly evolving fintech space.

Poised to Change How the World Does Business—Though blockchain technology faces challenges, the technology is changing many sectors in the U.S. and around the globe, from financial services and healthcare, to international shipping and economic development.

The use of blockchain technology by financial institutions already reached the early adoption phase in 2016, according to Accenture. And it's estimated that fully 10% of world GDP could be stored on blockchain technology by 2025, according to a World Economic Forum (or by 2027, according to Deutsche Bank.)

Anti-inflationary—While a central authority can unilaterally inflate a traditional currency by printing more money, a legitimate cryptocurrency has an anti-inflationary process built into its code. Bitcoin's, for example, limits the production of monetary units to 21 million by 2140. This feature could make Bitcoin, or its peers, viable alternatives in countries with dysfunctional economies, where currencies have lost both value and public confidence.

ENDNOTES:

[1]*See*, for example, https://medium.com/@dennyk/crypto-and-Bitcoin-adoption-how-far-along-are-we-really-in-this-rally-79b5539dc222.

[2]The World Bank, The Global Findex, 2018, http://www.worldbank.org/en/news/press-release/2018/04/19/financial-inclusion-on-the-rise-but-gaps-remain-global-findex-database-shows.

[3]Global Cryptocurrency Benchmarking Study, Dr Garrick Hileman and Michel Rauchs, University of Cambridge, Judge Business School, 2017 (sponsored by Visa), figure 97, p 109; *available at* https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2017-global-cryptocurrency-benchmarking-study.pdf.

[4]Global Cryptocurrency Benchmarking Study, p 108. *See* https://coinmarketcap.com/historical (last accessed March 24, 2017).

[5]*See* https://www.ccn.com/van-eck-responds-to-secs-Bitcoin-etf-concerns-in-new-letter.

CONGRESS PASSES CFIUS REFORM BILL

By Paul Marquardt, Katherine Mooney Carroll & Chinyelu Lee

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On August 1, the U.S. Senate joined the U.S. House of Representatives in agreeing to a conference report that sent the National Defense Authorization Act for Fiscal Year 2019 (NDAA), which incorporated a version of the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), to President Donald J. Trump for his signature.[1] The President is expected to sign the NDAA.

FIRRMA updates the statute authorizing reviews of foreign investment by the Committee on Foreign Investment in the United States (CFIUS) to reflect changes in CFIUS' practice over the 10 years since the last significant reform, expands CFIUS' jurisdiction, and makes significant procedural alterations to the CFIUS process. Introduced to "modernize and strengthen" review of foreign investment in the United States, FIRRMA cements a relatively aggressive approach to foreign investment review. However, ultimately, FIRRMA's changes to current CFIUS practice are modest, and many of the changes merely codify practices in place since the later years of the Obama Administration.

FIRRMA:

- Expands the scope of transactions covered by CFIUS to include:
  - a broader range of non-controlling foreign investment involving sensitive personal data of U.S. citizens, U.S. critical technology, and U.S. critical infrastructure (bearing in mind that CFIUS already routinely reviews investments falling far short of majority control);
  - most transactions involving real estate at (or functioning as part of) sea ports and airports in the United States or proximate to (or otherwise permitting surveillance of) military or sensitive government facilities located in the United States;
  - any change in rights of an existing investment that triggers a standard of review;
  - bankruptcy proceedings and other defaults on debt; and
  - transactions structured to "evade" CFIUS review;
- Provides for a short-form "declaration" procedure for less problematic transactions;
- For the first time, creates mandatory filings of declarations prior to investments involving sensitive personal data of U.S. citizens, U.S. critical technology, and U.S. critical infrastructure by non-U.S. persons in which non-U.S. governments have a "substantial interest";
- Extends the official time allotted for CFIUS reviews and investigations (but limits the time available for pre-notification review);
- Authorizes CFIUS to impose filing fees, which will be used to fund CFIUS' staff and operations;
- Updates CFIUS enforcement powers, including with respect to mitigation agreements;
- Adds additional national security factors for CFIUS to consider;
- Slightly adjusts the available judicial review of CFIUS decisions; and
- Provides for information-sharing with U.S. allies in connection with a transaction.

Equally importantly, FIRRMA does not incorporate earlier proposals to give CFIUS broader authority over export controls, technology joint ventures, and other non-equity transactions.[2] Earlier proposals to do so, strongly resisted by U.S. technology companies, were dropped, as were proposals to "blacklist" or "whitelist" certain jurisdictions.

Background

The Exon-Florio amendments to the Defense Production Act of 1950 (50 U.S.C.A. § 4565) and their implementing regulations (*See*,31 C.F.R. part 800) (together, "Exon-Florio") authorize the President to suspend or prohibit foreign acquisitions, mergers, or takeovers of U.S. businesses that threaten to impair the national security of the United States. CFIUS, which conducts reviews of transactions under Exon-Florio, is an interagency committee of representatives from various government agencies and offices that may approve the transaction, clear a transaction subject to conditions, or recommend that the President issue an order to block the transaction (or require divestment if the transaction already has occurred).[3]

FIRRMA addresses long-term, bipartisan trends in foreign investment review. Although the Trump Administration's trade-related conflicts have captured recent headlines, most of the proposals in FIRRMA reflect shifts in CFIUS practice and areas of concern that began in the Obama administration or earlier. In particular, the primary sponsors of FIRRMA have focused on the nature of Chinese outbound investment to the United States, which reached a record $65 billion in 2016:[4] Senator John Cornyn has described Chinese investment as "weaponize[d],"[5] and Representative Robert Pittenger has called it "a strategic, coordinated, Chinese government effort to target critical American infrastructure."[6] This focus on China, however, is not new. FIRRMA's updated catalog of potential national security issues is also consistent with issues identified by CFIUS reviews in recent years. Finally, FIRRMA's procedural provisions attempt to address longstanding issues with the CFIUS process, timing, and funding.

Primary Changes to CFIUS Review

Expanding CFIUS Jurisdiction

Exon-Florio nominally applies to potential acquisitions of "control" (defined in part as "the power, direct or indirect. . . to determine, direct, or decide important matters affecting an entity")[7] of a "U.S. business."[8] However, CFIUS has long examined transactions in which a foreign party acquires some governance rights falling well short of affirmative control. CFIUS' existing regulations provide a presumptive (not absolute) "safe harbor" for transactions in which a foreign person acquires less than 10% of the voting interest in a U.S. business solely for the purpose of passive investment (including, *inter alia*, an absence of board representation);[9] in practice, CFIUS has tended to treat any transaction not meeting those criteria (as well as any transaction providing a foreign person with any form of contractual veto or *de facto* approval right over significant decisions) as potentially subject to review. In addition, historically CFIUS has not had jurisdiction over purchases of assets that do not in the aggregate constitute an operable business, such as raw real estate.

FIRRMA confirms and builds upon existing practice by formally expanding CFIUS' jurisdiction to include:

- investments involving "sensitive personal data," "critical technology," or "critical infrastructure" that, if exploited, could threaten national security, unless the investment meets strict standards of passivity;

- purchases or leases of, or concessions regarding real estate that is—
  - located in or part of airports or sea ports; or
  - proximate to (or otherwise permitting surveillance of) military or sensitive government facilities located in the United States;
- any change in rights of an existing investment that would result in foreign control of a U.S. business or trigger the "sensitive personal data," "critical technology," or "critical infrastructure" tests above; and
- any transaction designed to evade or circumvent CFIUS review.[10]

In addition, under FIRRMA, "covered transaction" includes any transaction that otherwise fits the definition but "arises pursuant to a bankruptcy proceeding or other form of default on debt."[11] Most of these transactions were, in practice, already subject to CFIUS review; the major change is in real estate acquisitions, which, standing alone, have been treated as non-reviewable acquisitions of assets rather than of a "U.S. business."

Other Investments—FIRRMA gives CFIUS jurisdiction to review non-controlling "other investments" in companies that:

i. own, operate, manufacture, supply, or service critical infrastructure;[12]

ii. produce, design, test, manufacture, fabricate, or develop one or more critical technologies (defined as a wide range of export-controlled technologies);[13] or

iii. maintain or collect sensitive personal information of United States citizens that may be exploited in a manner that threatens national security.[14]

An investment in one of the companies above is a non-controlling "other investment" subject to review—regardless of percentage ownership—if it is a direct or indirect investment by a foreign person that affords that foreign person:

i. access to any material nonpublic technical information;[15]

ii. membership or observer rights on the board of directors or equivalent of the U.S. business, or the right to nominate a director; or

iii. any involvement (other than through the voting of shares) in substantive decision-making related to sensitive personal data, critical technologies, or critical infrastructure.[16]

However, FIRRMA permits a foreign investor to maintain certain consultation rights with respect to indirect investments through a fund managed exclusively by a U.S. general partner, managing member, or equivalent (each, a "US GP Equivalent") without triggering the "other investment" rules. A foreign investor may participate in an advisory committee or other body of such a fund (at fund level, not portfolio company level), so long as:

i. the committee does not have the ability to approve, disapprove, or otherwise control investment decisions of the fund or of the U.S. GP Equivalent with respect to any portfolio company, and

ii. the foreign investor itself cannot otherwise

> approve, disapprove, or otherwise control investment decisions of the fund, decisions of the U.S. GP Equivalent with respect to any portfolio fund, unilaterally decide (or, crucially, block) the appointment, removal, or compensation of the U.S. GP Equivalent, or obtain access to material nonpublic technical information via the advisory committee.

The investment must also otherwise comply with the rules above.[17] The right (pursuant to terms of an agreement) of a foreign person investor or an advisory board or committee to waive potential conflicts of interest, waive allocation limitations, or engage in "a similar activity" would not be deemed to be control of the investment decisions of the fund or decisions relating to entities in which the fund is invested.[18] Further conditions could be adopted by regulation.

Perhaps most importantly, as discussed below in Section 2.c, investments by entities in which a foreign government holds a "substantial" interest are exempted from the mandatory filing of a declaration if they are made via a fund directed by a U.S. GP Equivalent meeting the criteria above.

Real Estate—FIRRMA expands CFIUS jurisdiction to include acquisitions of interests in real estate proximate to seaports, airports, and military or other sensitive government facilities, but it excludes single housing units and, except as specified by CFIUS in regulations, real estate in urban areas from CFIUS' expanded jurisdiction.[19] Under prior rules, acquisitions of real estate were not considered covered transactions unless enough other assets were acquired to constitute an operating business. FIRRMA does not include language from the pre-conference Senate version of the bill that would have extended a carve out for investors from whitelisted jurisdictions to the Committee's expanded jurisdiction over real estate transactions.[20]

Short-Form "Declarations"

FIRRMA creates a new short-form filing, or "declaration," that would permit the parties to file an abbreviated notice (targeted for five pages or less) describing basic information regarding the transaction.[21] Based on the declaration, CFIUS could (*i*) clear the transaction, (*ii*) request that the parties file a full notice, (*iii*) inform the parties that CFIUS is unable to conclude action under Exon-Florio on the basis of the declaration (in which case, parties could voluntarily file a full notice to have the transaction cleared by CFIUS), or (*iv*) initiate a unilateral review of the transaction.[22] CFIUS will be required to reach one of the four decisions listed above within 30 days of receipt of a declaration, and it is not permitted to request that the parties withdraw and refile a declaration except in cases of material inaccuracy.[23]

It remains to be seen whether declarations will be a useful tool. Although Congress appears to be acknowledging that some transactions are less sensitive than others and do not warrant a full filing, one might reasonably ask whether there is much point to making a voluntary filing at all in cases that do not raise significant issues. However, some parties may be interested in making such filings to try to obtain the safe harbor of a clearance. However, unless it is obvious that there are no national security issues (or that CFIUS lacks jurisdiction, a finding it rarely makes), it seems unlikely that CFIUS will clear many transactions on the basis of a 5-page declaration, and if CFIUS proceeds to a full examination of the transaction, the filing of a short-form declaration merely adds another 30 days to the process.

Mandatory Filing of Declarations

Although CFIUS has the authority to initiate reviews and subpoena information in the absence of a voluntary filing, at present the CFIUS process is voluntary in the first instance.[24] Under FIRRMA, filing of a declaration will be mandatory for acquisition, directly or indirectly, of a "substantial interest" in a U.S. business that (*i*) owns, operates, manufactures, supplies or services critical infrastructure,[25] (*ii*) produces, designs, tests, manufactures, fabricates, or develops one or more critical technologies,[26] or (*iii*) maintains or collects sensitive personal data by a foreign person in which a foreign government owns, directly or indirectly, a "substantial interest."[27] FIRRMA leaves "substantial interest" to be defined by regulation but prohibits CFIUS from considering investments of less than a 10% voting interest or non-controlling investments that would not be reviewable as "other investments" under FIRRMA to be "substantial."[28] FIRRMA also permits CFIUS to issue regulations requiring filings of transactions involving critical technology irrespective of interests held by foreign governments.[29] The parties can instead opt to submit a full filing, which would be sensible if a full review is anticipated (as a declaration would simply add 30 days to the process).

FIRRMA permits CFIUS to waive the requirements for mandatory declarations "if the Committee determines that the foreign person demonstrates that the investments of the foreign person are not directed by a foreign government and the foreign person has a history of cooperation with the Committee."[30] In practice, establishing the requisite elements for the waiver is unlikely to be materially less burdensome than producing a mandatory declaration; however, the waiver process is left for later regulations and is unclear.

Together with mandatory declarations, FIRRMA introduces mandatory waiting periods for closing. At present, parties are able to close transactions (subject to the ability of CFIUS to issue interim orders and at the parties' risk) despite the pendency of a CFIUS review. FIRRMA requires parties to submit mandatory declarations by a date set by CFIUS that can be no earlier than 45 days prior to closing.[31]

Reforms to the CFIUS Timeline

FIRRMA includes provisions meant to reform the timetable for CFIUS review. Under current law, the CFIUS timeline is nominally 30 days for an initial review, 45 days for a second-stage investigation, and (rarely) 15 days for a presidential determination.[32] However, the statutory timetable only commences after CFIUS accepts the parties' notice; in recent years, CFIUS has expanded an informal review originally intended to determine whether a filing was complete to take ever-increasing amounts of time. CFIUS has also with increasing frequency pressured parties to "voluntarily" withdraw and resubmit notices to re-start the review periods. Taking into account the pre-acceptance period and the ability of CFIUS to request that parties withdraw and resubmit notices, the statutory review period has become increasingly illusory.

FIRRMA extends, but attempts to firm, the statutory timeline for CFIUS proceedings. FIRRMA attempts to add certainty to the pre-filing period, requiring CFIUS to either accept a CFIUS notice or provide comments explaining why the notice is materially incomplete within 10 business days after submission of a draft, so long as the parties stipulate that a transaction is a "covered transaction" within CFIUS jurisdiction.[33] The initial review is extended from 30 to 45 days, under FIRRMA, followed by, if necessary, a 45-day investigation that can be extended by an additional 15 days by the Secretary or Deputy Secretary (or equivalent) of the Department of Treasury or the lead agency in "extraordinary" circumstances.[34] Finally, FIRRMA addresses government shutdowns, tolling CFIUS' statutory deadlines during any lapse in appropriations.[35]

These changes to the formal timetable may reduce the frequency of CFIUS' bending its rules to extend that timetable, but their impact obviously remains to be seen. Nothing in FIRRMA prohibits CFIUS' practice of asking parties to withdraw and refile notices (backed by the implicit or explicit threat of a prohibition if the notice is not withdrawn) if the review runs past the statutory timetable.

CFIUS Filing Fees

The U.S. government does not currently charge fees for CFIUS filings. FIRRMA permits CFIUS to collect filing fees for notifications; this dedicated funding source is intended to provide additional CFIUS staff to address current delays and anticipated increased future volume of notifications.[36] The act authorizes CFIUS to charge filing fees that do not exceed an amount equal to the lesser of 1% of the value of the transaction or $300,000, as adjusted annually for inflation, so long as the total fees collected do not exceed the cost of administering CFIUS.[37] FIRRMA also instructs CFIUS to study the feasibility and merits of a supplemental filing fee for expedited treatment of draft notices.[38] FIRRMA requires CFIUS to periodically update the filing fee and, in setting the fee, consider factors such as (*i*) the effect on small business, (*ii*) CFIUS' expenses, and (*iii*) the effect on foreign investment.[39]

Side Agreements

FIRRMA authorizes CFIUS to issue regulations formalizing the requirement that parties submit all partnership agreements, integration agreements, and other side agreements relating to a transaction.[40]

Updated Enforcement Powers

FIRRMA codifies existing practice and, in some cases, gives CFIUS additional tools to enforce remedies addressing national security issues identified with respect to covered transactions. Additional enforcement authority under FIRRMA includes:

- Explicit authority at the Committee level to order the parties to suspend a transaction during CFIUS review;
- The ability to refer a transaction to the President for action even before CFIUS review is complete;
- Greater oversight power over mitigation agreements, including the power to initiate an enforcement action for unintentional breaches of mitigation agreements; and
- The power to impose mitigation conditions on a party that has abandoned a transaction.[41]

Reflecting issues raised by a recent GAO report on the challenges confronting the Department of Defense's efforts to oversee an ever-increasing docket of mitigation agreements,[42] FIRRMA provides statutory authority for CFIUS to "terminate, phase out, or otherwise amend" mitigation agreements or conditions and requires the lead agencies to develop and maintain an explicit plan to monitor and enforce any mitigation agreement imposed.[43]

Judicial Review

FIRRMA makes adjustments to the available judicial review of CFIUS decisions. The U.S. Court of Appeals for the D.C. Circuit will have exclusive jurisdiction over civil actions challenging an action or finding of the committee; the court will have an opportunity for *ex parte* and *in camera* review of the classified record, if the court determines that the use of such information is necessary; and the government will be able to use information obtained pursuant to the Foreign Intelligence Surveillance Act.[44] Exon-Florio's existing bar against judicial review of the President's substantive determination of whether a transaction threatens national security and what action is necessary to address the threat remains in place.[45]

Information Sharing with Foreign Governments

FIRRMA permits CFIUS to share information with any domestic or foreign governmental entity of a U.S. ally or partner to the extent necessary for national security purposes and subject to appropriate confidentiality and classification requirements, highlighting a trend in recent transactions toward international consultation regarding perceived threats (and the increasing prevalence of foreign investment reviews related to national security).[46] FIRRMA instructs CFIUS to set up a formal information sharing process between the United States and its allies and partners.[47]

Additional National Security Considerations

FIRRMA contains "sense of Congress" language listing national security considerations CFIUS may wish to take into account (most of which are consistent with existing CFIUS practice), including:

- whether a covered transaction involves a country of special concern that has a demonstrated or declared strategic goal of acquiring a type of critical technology or critical infrastructure that would affect United States leadership in areas related to national security;
- the potential national security-related effects of the cumulative control of, or pattern of recent transactions involving any one type of critical infrastructure, energy asset, critical material, or critical technology by a foreign government or foreign person;
- whether any foreign person engaging in a covered transaction with a U.S. business has a history of complying with U.S. laws and regulation;
- the control of U.S. industries and commercial activity by foreign persons as it affects the capability and capacity of the United States to meet the requirements of national security, including the availability of human resources, products, technology, materials, and other supplies and services, and in considering the availability of human resources, should construe that term to

include potential losses of such availability resulting from the reductions in the employment of U.S. persons whose knowledge or skills are critical to national security;

- the extent to which the transaction is likely to release, either directly or indirectly, sensitive personal data of U.S. citizens to a foreign person that may exploit that information in a manner that threatens national security; and

- whether the transaction is likely to exacerbate cybersecurity vulnerabilities or are likely to result in a foreign government gaining a significant new capability to engage in malicious cyber-enabled activities against the United States, including such activities designed to affect the outcome of any election for federal office.[48]

Effective Dates

The following significant substantive provisions of FIRRMA are immediately effective:

- Expansion of CFIUS jurisdiction to cover changes in rights that could result in acquisitions of control of a U.S. business by a foreign person and any transactions designed or intended to evade or circumvent the definition of covered transaction;

- Amendment of the CFIUS timetable to provide for a 45-day initial review and a 15-day extension of the investigation phase in extraordinary circumstances;

- Imposition of a filing fee (though the amount of the fee must be set by regulation);

- Expansion of authority to impose, enforce, and monitor mitigation agreements and suspend transactions pending review;

- Clarification of CFIUS authority to require notice submissions to include partnership, integration, and side agreements;

- Provision for information sharing with allies; and

- Modifications to judicial review.[49]

The remaining provisions, including review of real estate transactions, expansion of review of non- controlling investments in critical infrastructure, critical technology, and sensitive personal data, introduction of short-form notifications, and mandatory filings for state-linked transactions, will not be effective until the earlier of 18 months after adoption of the statute or 30 days after adoption of implementing regulations (and certification by the Secretary of the Treasury that the necessary resources are in place). CFIUS also has authority to implement pilot programs for the remaining provisions on at least 30 days' notice. Although the timetable is uncertain, we would expect the adoption of final implementing regulations to take at least approximately a year.

ENDNOTES:

[1]H.R. Rep. No. 115-874, at 540-608 (2018) (Conf. Rep.) [hereinafter NDAA]. For prior iterations of the bill *see, e.g.*, John S. McCain National Defense Authorization Act for Fiscal Year 2019, H.R.5515, 115 Cong. §§ 1701-33 (2018) [hereinafter Pre- Conference NDAA]; Foreign Investment Risk Review Modernization Act of 2018, H.R. 5841, 115 Cong. (2018) [hereinafter House 2018 FIRRMA]; Foreign Investment Risk Review Modernization Act of 2018, S. 2098, 115 Cong. (2018) [hereinafter Senate 2018

FIRRMA]; Foreign Investment Risk Review Modernization Act of 2017, H.R. 4311, 115 Cong. (2017) [hereinafter House 2017 FIRRMA]; Foreign Investment Risk Review Modernization Act of 2017, S. 2098, 115 Cong. (2017) [hereinafter Senate 2017 FIRRMA].

[2]*See* Senate 2017 FIRRMA § 3 (covering "the contribution (other than through an ordinary customer relationship) by a United States critical technology company of both intellectual property and associated support to a foreign person through any type of arrangement, such as a joint venture"); House 2017 FIRRMA § 3. FIRRMA includes provisions to establish an interagency process to define emerging and foundational technologies and generally expand the authority of the United States to impose unilateral measures to control the export of such technologies. NDAA § 1758. Following House 2018 FIRRMA, FIRRMA also enacts the Export Control Reform Act of 2018 to replace the Export Administration Act of 1979. NDAA §§ 1741-42, 51-68.

[3]To learn more about CFIUS, see our alert memorandum, Recent Revisions to Exon-Florio "National Security" Reviews of Foreign Investment in the United States (Dec. 22, 2008).

[4]Nicholas Farfan and Karl But, New Hurdles Trip Up China-US M&A. How Has Growing Regulatory Scrutiny Affected Cross-border Activity? Dealogic Research (Aug. 8, 2017).

[5]Foreign Investments and National Security: A Conversation with Senator John Cornyn, Council on Foreign Relations (June 22, 2017).

[6]Press Release, U.S. Congressman Robert Pittenger, Taking Aim at China: Pittenger and Cornyn Introduce Legislation to Enhance National Security Review of Foreign Investment in the United States (Nov. 8, 2017).

[7]31 C.F.R. § 800.204(a).

[8]The current regulatory definition of "United States business" is "any entity, irrespective of the nationality of the persons that control it, engaged in interstate commerce in the United States, but only to the extent of its activities in interstate commerce." 31 C.F.R. § 800.226. FIRRMA adds a statutory definition of "United States business" as "any person engaged in interstate commerce in the United States," which tracks the existing Exon-Florio language in the pre-FIRRMA statutory definition of "covered transaction" ("any merger, acquisition, or takeover. . .by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States"). NDAA § 1703; 50 U.S.C. § 4565(a)(3). In our view, the statutory language neither demands nor precludes the regulatory gloss of "to the extent of its activities in interstate commerce"; as nothing in the statements of the sponsors or the congressional summaries of FIRRMA indicates an intent to expand CFIUS' jurisdiction beyond operations physically located in the United States, we think it unlikely that any such change was intended.

[9]31 C.F.R. § 800.302(b).

[10]NDAA § 1703.

[11]Id.

[12]"Critical infrastructure" is defined, subject to regulation, as "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national
security." *Id.*

[13]"Critical technologies" is defined to include:

(i) "Defense articles or defense services included on the United States Munitions List set forth in the International Traffic in Arms Regulations under subchapter M of chapter I of title 22, Code of Federal Regulations.

(ii) Items included on the Commerce Control List set forth in Supplement No. 1 to part 774 of the Export Administration Regulations under subchapter C of chapter VII of title 15, Code of Federal Regulations, and controlled —

I. pursuant to multilateral regimes, including for reasons relating to national security, chemical and biological weapons proliferation, nuclear non-proliferation, or missile technology; or

II. for reasons relating to regional stability or surreptitious listening.

(iii) Specially designed and prepared nuclear equipment, parts and components, materials, software, and technology covered by part 810 of title 10, Code of Federal Regulations (relating to assistance to foreign atomic energy activities).

(iv) Nuclear facilities, equipment, and material covered by part 110 of title 10, Code of Federal Regulations (relating to export and import of nuclear equipment and material).

(v) Select agents and toxins covered by part 331 of title 7, Code of Federal Regulations, part 121 of title 9 of such Code, or part 73 of title 42 of such Code.

(vi) Emerging and foundational technologies controlled pursuant to section 1758 of the Export Control Reform Act of 2018." *Id.*

[14]Id.

[15]"Material nonpublic technical information" is defined as information that "provides knowledge, know-how, or understanding, not available in the public domain, of the design, location, or operation of critical infrastructure; or. . . is not available in the public domain, and is necessary to design, fabricate, develop, test, produce, or manufacture critical technologies, including processes, techniques, or methods." NDAA § 1703. Financial information on the performance of the U.S. business is specifically excluded.

[16]*Id.*

[17]Id.

[18]*Id.*

[19]Id.

[20]*Id.*

[21]NDAA § 1706.

[22]Id.

[23]*Id.*

[24]*See, e.g.*, 31 C.F.R. § 800.701(a).

[25]*See supra* n. 12.

[26]*See supra* n. 13.

[27]*See* NDAA § 1706.

[28]NDAA § 1706.

[29]*Id*. The pre-conference Senate version of FIRRMA would have also empower CFIUS to designate additional areas that would be subject to mandatory declarations but would have require that they be based on the following factors: (i) the sector involved, (ii) difficulty remedying any harm to national security post-closing of the transaction, or (*iii*) difficulty of otherwise obtaining information about a particular type of transaction. Pre-Conference NDAA § 1706.

[30]Id.

[31]NDAA § 1706.

[32]50 U.S.C.A. § 4565(b)(1)(E), (2)(C).

[33]NDAA § 1704.

[34]NDAA § 1709.

[35]NDAA § 1709.

[36]NDAA § 1723.

[37]*Id.*

[38]*Id*. The pre-conference Senate bill would have implemented a prioritization fee with the enactment of FIRRMA. Pre- Conference NDAA § 1722.

[39]NDAA § 1723.

[40]NDAA § 1705.

[41]NDAA § 1718.

[42]*See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFF., GAO-18-494, COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES: ACTION NEEDED TO ADDRESS EVOLVING NATIONAL SECURITY CONCERNS FACING THE DEPARTMENT OF DEFENSE 18 (2018).

[43]NDAA § 1718.

[44]NDAA § 1715. Foreign Intelligence Surveillance Act of 1978 use of information provisions would not apply in a civil action brought against the committee. *Id*.

[45]50 U.S.C.A. § 4565(e).

[46]NDAA § 1713.

[47]Id.

[48]NDAA § 1702(c).

[49]*Id.*

GROUPS COME OUT SUPPORTING & OPPOSING SEC'S "BEST INTEREST" PROPOSAL

From WSL Staff Reports

In mid-April, the Securities and Exchange Commission (SEC) voted to propose a package of new rules and interpretations to improve on the quality and transparency of investors' relationships with their investment advisers and broker-dealers. The rules also sought to preserve investors' access to many different types of advice relationships and investment products.

Under the proposed Regulation Best Interest, a broker-dealer would be required to act in the "best interest" of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. Indeed, the proposed rule was crafted to ensure that a broker-dealer may not put its financial interests ahead of the interests of a retail customer in making recommendations, according to the SEC.

As part of the package of rules, the SEC said it also proposed an interpretation of some existing rules to reaffirm and clarify the Commission's views of the concept of fiduciary duty so that investment advisers and their clients would have greater clarity about advisers' legal obligations.

Finally, the SEC also proposed a new short-form disclosure document that would summarize the investor's relationship with the investment advisory—Form CRS.

Overall, the proposed rules and interpretations would enhance investor protection by applying consistent principles to investment advisers and broker-dealers, requiring such services as: providing clear disclosures; exercising due care; and addressing conflicts of interest, the SEC said.

The rules then began a public comment period which has elicited thousands of comments[1] of enthusiastic support, sharp criticisms of the proposals, and notes and suggestions of how the proposals could be tinkered with to be made better.

Two groups' comments, detailed below, give an insight into the public thinking about the SEC's Best Interest rule and related other rules.

The Investment Company Institute

In a 43-page comment letter,[2] the Investment Company Institute (ICI)—the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs)—said in its August 7 letter and related announcement that it supports the SEC's recent efforts "to ensure that retail investors, whether they are investing for retirement or other important goals, are afforded strong protections when they receive recommendations from a financial professional."

The ICI suggested that "with some refinements. . . the SEC's proposed Standards of Conduct for Investment Professionals[3] will create an effective framework for achieving the SEC's objectives—including promoting investment recommendations in investors' best interest and preserving investors' option to choose the type of investment professional who can best help them pursue their investing goals."

More specifically, the ICI recommended several modifications to the SEC's proposals to better achieve the agency's goals, including the following:

Addressing Conflicts of Interest

The SEC should clarify when and how a broker-dealer must address conflicts of interest, especially regarding recommendations of products that are proprietary or limited in range (see letter, page 20). ICI recommends an approach that would be consistent with the DOL's approach in the fiduciary rule and would appropriately focus the mitigation obligation on incentives that create a material conflict of interest for the representative that may influence the recommendation to the customer.

Considering Fees and Expenses

The SEC should confirm that a broker-dealer recommending funds:

- May consider a variety of important factors, in addition to cost, in making a recommendation.[4]
- May direct customers to the detailed, standardized information about fund fees and expenses in the fund prospectus, rather than independently calculating fund fees.[5]
- Would not be required to calculate fees and expenses on an individualized basis at the beginning of the relationship or before making a recommendation. Predicting and providing prospective fee information would involve significant challenges and costs, and extensive fund fee information already is readily available, as required by existing regulations.[6]

Proposed Interpretation of Adviser's Fiduciary Duty

The SEC should refine its interpretation to make it more consistent with existing law by:

- Clarifying the scope and applicability of an adviser's fiduciary duty, recognizing key differences between institutional advisory relationships and the retail advisory relationships that are the focus of the SEC's interpretation.[7]
- Confirming that the existing standard under the Advisers Act for a client's consent to conflicts is whether the adviser has provided full and fair disclosure of material conflicts and obtained informed client consent.[8]

In answer to the SEC's question in the proposal about applying broker-dealer rules—such as licensing requirements—to the investment adviser regulatory regime, ICI recommended that the SEC not pursue these changes, noting that the SEC has neither articulated why these potential changes would be beneficial nor addressed key concerns and questions they raise.[9]

The Public Investors Arbitration Bar Association

The Public Investors Arbitration Bar Association—an international, not-for-profit, voluntary bar association of lawyers who represent claimants in securities and commodities arbitration proceedings and securities litigation—was critical of the current form of the SEC's proposed Best Interest Standard rule, and it outlined 15 major changes to the SEC Rule Proposal that it would like to see in order, the group said, "to ensure conflicts of interest adequately disclosed, investor needs and limits are recognized."

In a report, also released on August 7, the PIABA stated that unless the SEC makes the report's suggested 15 major changes to its "Best Interest Standard" rule proposal, the Commission "will further perpetuate the status quo of allowing Wall Street brokerage firms and brokers to peddle high cost, conflict laden investments and investment strategies."

The report, *Recommendations to Improve and Enhance the SEC Best Interest Standard for Investors*,[10] outlines more than a dozen specific ways to improve conflict-of-interest protections, protect investors' best interests, and ensure adequate and clear disclosure to investors, according to the PIABA.

"There is an overwhelming need for a strong, investor centric best interest standard. Americans are woefully unprepared for retirement and meeting other financial goals. Decades of conflicted advice and high fee investments by brokerage firms directly led to this crisis. Half of all Americans have less than $10,000 in savings, and nearly half of the oldest Baby Boomers are at risk of not having sufficient retirement resources to pay for basic retirement expenses and healthcare costs. The Center for Retirement Research at Boston College estimates that our 'retirement income deficit' is $6.6 trillion," the PIABA report notes. "That number represents the gap between the pension and retirement savings that American households have today and what they should have today to maintain their standard of living in retirement."

In summary form, the 15 PIABA recommendations are:

1. Ban certain "financial incentives" such as sales contests which reward brokers for selling particular products or types of products, such as a week-long trip to Playa Del Carmen, Mexico and/or a hotel stay for two in Dublin to the top sellers of annuities within brokerage firms.

2. Prohibit extra compensation for selling in-house products or one product line over another.

3. Require clear and understandable disclosure of fees, charges and compensation associated with a recommendation, prior to or at the time the recommendation is made and a clear and understandable explanation as to other lower cost investments which are available, and why the higher cost investment is being recommended.

4. Put the burden of accurately recording customer information on the broker and/or firm and make sure that the customer information is kept current.

5. Require brokers to take reasonable steps to verify that the financial information provided by an investor is accurate.
6. Require real "due diligence" review of products that go beyond the information that is provided by product wholesalers and/or issuers.
7. If there are less expensive alternatives available, the disclosure to investors should include an explanation to the customer of why the recommended, more-expensive investments product strategy is nevertheless in the customer's best interest.
8. The SEC rule must make it explicitly clear that brokers cannot satisfy their obligation merely by providing the customer with a prospectus or offering document. Otherwise, brokers may ignore their best interest duty by attempting to improperly shift the burden to the customer to assess the merits and risk of the investment.
9. Disclosure should be based on a direct conversation in which the broker explains the relationship, any potential and actual conflicts, how the broker is paid, and the features, benefits, and risks of the recommendation in a way that is understandable to the customer.
10. Brokers must be required to disclose the risks, benefits, and ramifications of the recommendation in a way that is understandable to the customer.
11. The rule should extend to any situation where the broker offers generalized retirement planning, financial or investment recommendations to a prospective customer, such as taking early retirement, electing a lump sum in lieu of a defined benefit pension, and refinancing a property to use the equity in order to make an investment
12. There should be a continuing duty on the part of the broker to periodically assess a recommended investment strategy to determine whether it remains in the customer's best interest.
13. The Best Interest Standard will remain in effect for as long as the broker is continuing to be compensated as a direct or indirect result of the recommendation.
14. The rule must make it clear that states are free to create and enforce a higher standard of conduct on brokers.
15. The rule may not preempt existing or future state statutory and common law which creates stronger protections for investors within their own jurisdictions, such as California and South Dakota's fiduciary requirements of brokers.

ENDNOTES:

[1]*See* https://www.sec.gov/comments/s7-07-18/s70718.htm#transcripts.

[2]*See* the ICI letter, *available at* https://www.ici.org/pdf/18_regulation_best_interest_ltr.pdf.

[3]*See* https://www.sec.gov/news/press-release/2018-68.

[4]*See* ICI letter, page 14.

[5]*See* ICI letter, page 8.

[6]*See* ICI letter, page 9.

[7]*See* ICI letter, page 29.

[8]*See* ICI letter, page 30.

[9]*See* ICI letter, page 34.

[10]For the full report, *see* https://piaba.org/piaba-newsroom/report-recommendations-improve-and-enhance-sec-best-interest-standard-investors.

FROM THE EDITORS

Will the SEC Go to Half-Year Corporate Reports at the President's Request?

In August, U.S. President Donald J. Trump said he had asked the Securities and Exchange Commission (SEC) to look into the potential impact of allowing U.S. companies to file financial reports every six months instead of every quarter.

As per his usual method, Pres. Trump argued *in a tweet* that the longer time frame would "allow greater flexibility & save money," although he didn't specify how that would happen. But, in reality, if the SEC would seek to change that policy the move would likely face a lengthy, difficult and uncertain path to passage.

While, of course, the SEC is an independent agency and doesn't necessarily cater to the whims or even the tweets of the Trump administration, several news outlets pointed out that SEC Chairman Jay Clayton, two of its three current Commissioners, and one additional individual pending before the U.S. Senate were all nominated by Pres. Trump. Still, as was also pointed out, the president cannot directly order the SEC to pursue specific changes.

If the SEC was to take up the issue on Trump's suggestion—the agency hasn't commented yet officially—the SEC staff would likely perform its own research, examine existing academic literature, and take on board industry feedback to begin to build the foundation for potential rule-changes.

Regulators can conduct studies of their own volition, or will do so at the request of Congress, the president, or the public. But there is no guarantee a study will lead to policymaking or regulatory changes. In fact, the Administrative Procedure Act outlines a robust process for changing regulations which requires an analysis of the costs and benefits that would have to justify the changes.

In addition to this federal requirement, SEC Chair Clayton would have to subject any changes to the SEC's own formal rule-making process, which would require the support of the majority of the SEC's sitting commissioners. He also would need to draft a proposed rule-change which would then be put to an industry consultation during which investors, companies, exchanges, pension funds, and public interest groups would likely bombard the SEC with information. (It's also important to remember that while the Securities Exchange Act of 1934 requires companies to report periodically, the SEC has the discretion to draw up or change the specific rules on how frequently this happens. But Congress could effectively overrule any SEC decision by passing a law requiring quarterly reporting.)

As we said, the SEC would need the majority of its sitting Commissioners to vote for the final changes. And, as the financial industry also knows well, the SEC rulemaking, particularly on contentious issues, can drag on for months if not years.

And of course, we at *Wall Street Lawyer* will keep an eye on this issue.

—Gregg Wirth, Managing Editor

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