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# Cravath Quarterly Review

FINANCE AND CAPITAL MARKETS

## Market Update

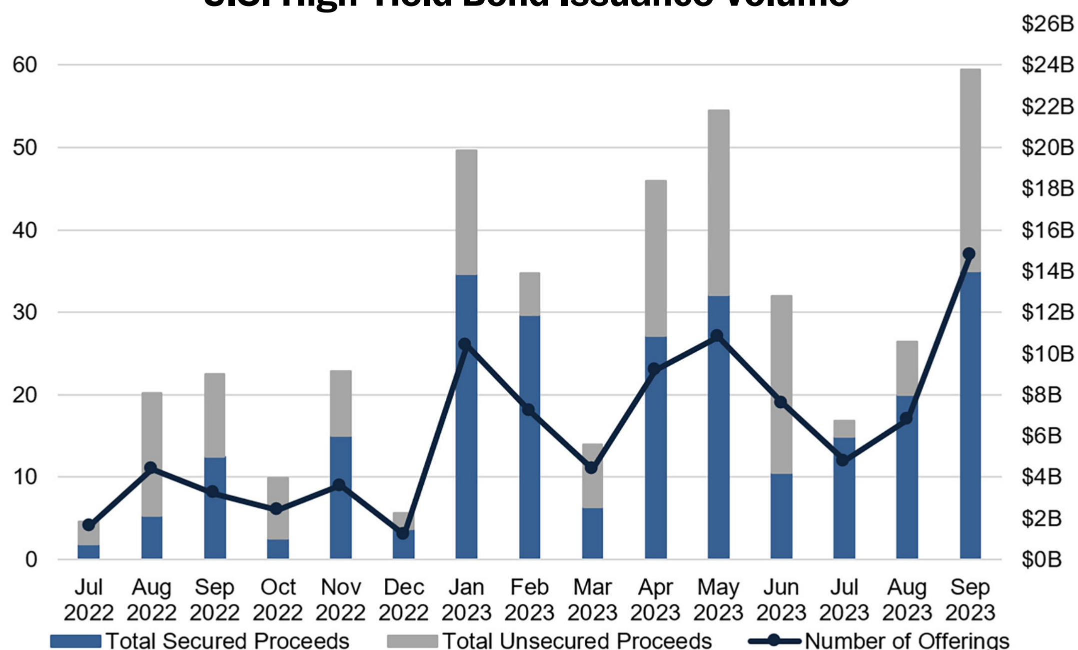
### GENERAL TRENDS

U.S. financing activity in the third quarter of 2023 generally decreased compared to the second quarter of 2023, but remained elevated from the levels seen in the second half of 2022. Activity in the U.S. high-yield and investment-grade bond markets declined relative to the second quarter of 2023 but were considerably higher than the second half of 2022. Activity in the U.S. syndicated leveraged loan market (including the leveraged buyout market) rose in the third quarter of 2023 as compared to the second quarter of 2023, but continued to remain below historical volumes. Activity in the direct lending market dipped slightly as compared to the second quarter of 2023 and remained lower than the third quarter of 2022, but continued to outpace the syndicated loan market for both leveraged buyouts ("LBOs") and non-LBOs in certain sectors. The number of and total proceeds from U.S. follow-on equity offerings in the third quarter of 2023 declined relative to the second quarter of 2023 but increased relative to the second half of 2022. In contrast, the increase in U.S. IPO activity seen in the second quarter of 2023 continued in the third quarter of 2023 and rebounded most notably in September from 2022 levels.

BONDS

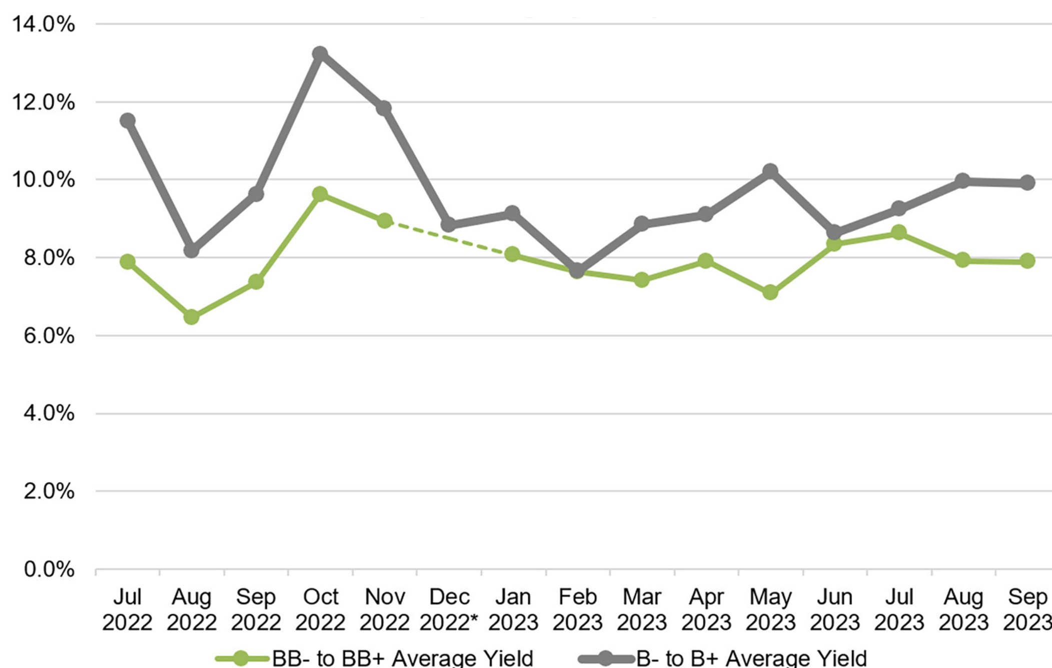
## *U.S. High-Yield Bonds*

Total proceeds from U.S. high-yield bond issuances were $41.1B in the third quarter of 2023, down 22.4% as compared to the second quarter of 2023 ($53B) and up 117.5% as compared to the third quarter of 2022 ($18.9B). The volume of U.S. high-yield issuances decreased from $12.8B in June to $6.7B in July, but increased to $10.6B in August and $23.8B in September. Total proceeds from secured bonds were $28B in the third quarter of 2023, up 254.7% as compared to $7.9B in the third quarter of 2022. Secured bonds continued to be popular, as issuers are increasingly offering collateral as a means to partially offset elevated borrowing costs.




DATA SOURCE Leveraged Commentary & Data (LCD)

The average yield on high-yield notes rated BB- to BB+ issued in the third quarter of 2023 was 8.1%, as compared to 7.8% in the second quarter of 2023 and 7.2% in the third quarter of 2022. The average yield on high-yield notes rated B- to B+ issued in the third quarter of 2023 was 9.7%, as compared to 9.3% in the second quarter of 2023 and 9.8% in the third quarter of 2022.

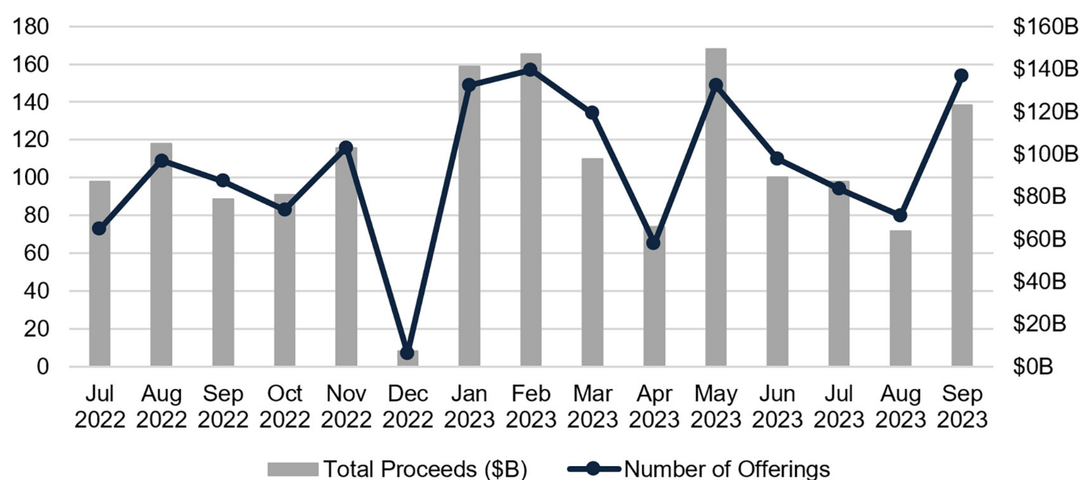



* No high-yield notes rated BB- to BB+ were issued in December 2022.

DATA SOURCE Leveraged Commentary & Data (LCD)

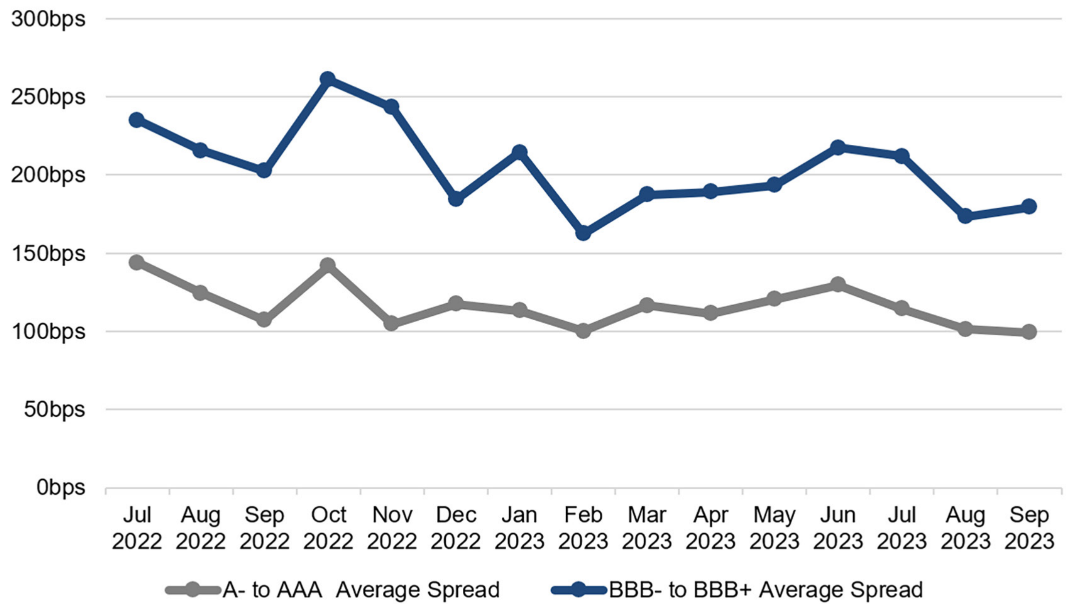
### *U.S. Investment-Grade Bonds*

Total proceeds from U.S. investment-grade issuances were $273.3B in the third quarter of 2023, down 10.1% from $303.9B in the second quarter of 2023 and up 1.1% from $270.5B in the third quarter of 2022. Total proceeds declined from $88.9B in June to $86.9B in July and $63.6B in August, but increased to $122.8B in September.




DATA SOURCE Leveraged Commentary & Data (LCD)

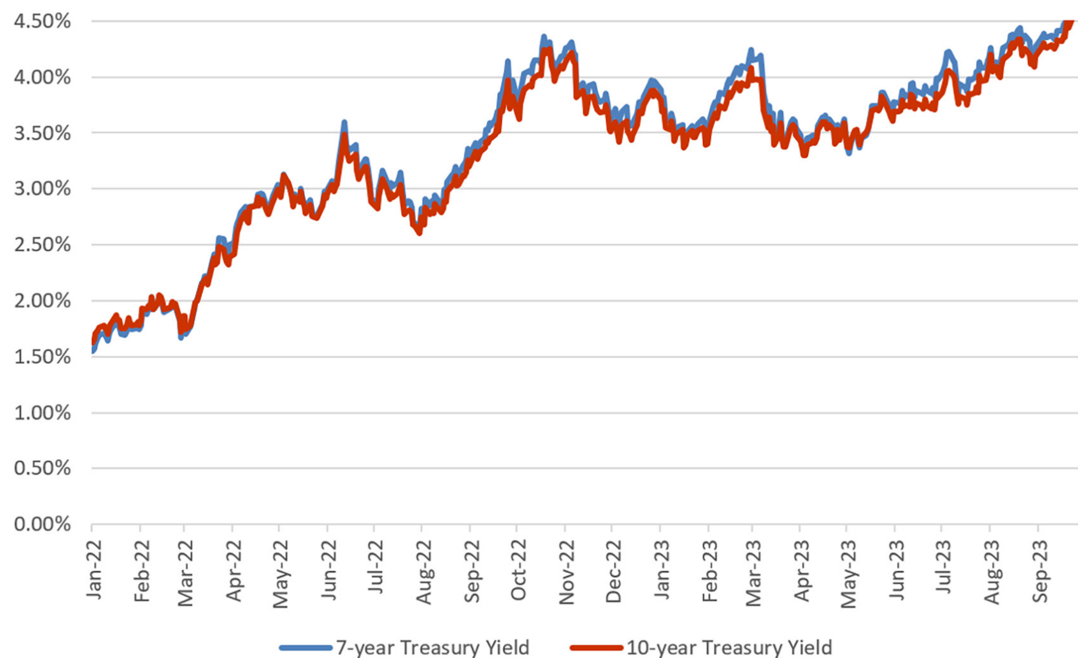
The average pricing spread (measured over the comparable Treasury) on U.S. issuances of investment-grade notes rated A- to AAA in the third quarter of 2023 decreased 12.8% as compared to the average pricing spread for the second quarter of 2023 and decreased 16.1% as compared to the average pricing spread for the third quarter of 2022. The average pricing spread (measured over the comparable Treasury) on U.S. issuances of investment-grade notes rated BBB- to BBB+ in the third quarter of 2023 decreased 5.9% as compared to the average pricing spread for the second quarter of 2023 and decreased 13.5% as compared to the average pricing spread for the third quarter of 2022.




DATA SOURCE Leveraged Commentary & Data (LCD)

*U.S. Treasury 7-year and 10-year Yields*

The Federal Reserve has been aggressively increasing interest rates since March 2022. U.S. Treasury 7-year and 10-year yields in the third quarter of 2023 increased 64 bps and 76 bps, respectively, as compared to the end of the third quarter of 2022, representing an increase of 16.1% and 19.8%, respectively. U.S. Treasury yields ended the third quarter of 2023 at 4.61% for 7-year yields and 4.59% for 10-year yields, up by 64 bps and 78 bps, respectively, as compared to the end of the second quarter of 2023, representing an increase of 16.1% and 20.5%, respectively. Notably, U.S. Treasury 7-year and 10-year yields in the third quarter of 2023 increased 249.2% and 202%, respectively, as compared to the end of the third quarter of 2021 and that trend continued in October 2023 with the yield on 10-year Treasuries crossing 5% for the first time since 2007.

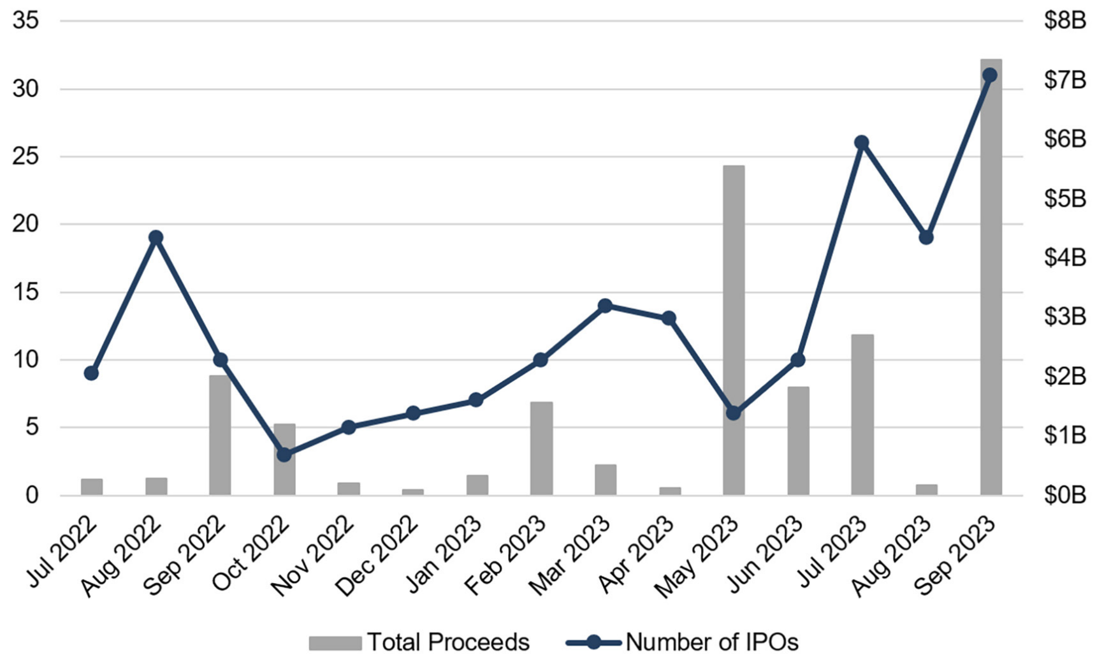



DATA SOURCE U.S. Department of the Treasury

EQUITY

## *U.S. IPOs*

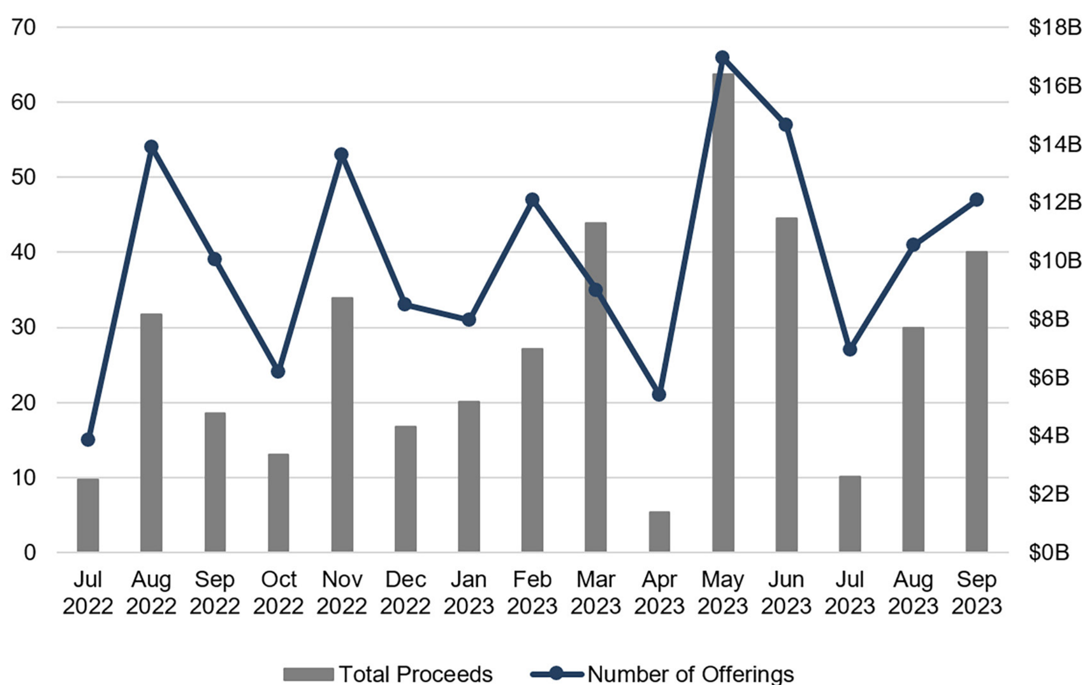
The U.S. IPO market in the third quarter of 2023 remained far less active compared to the record-setting levels seen in 2021, but rebounded most notably in September, which saw the highest total proceeds ($7.3B) for one month since January 2022. Of the $7.3B in total proceeds in September, $4.9B related to the U.S. IPO of Arm Holdings plc ("Arm"). The $10.2B in total proceeds from U.S. IPOs (not including SPACs) for the third quarter of 2023 was up 36% as compared to $7.5B in total proceeds in the second quarter of 2023 and up 299.1% as compared to $2.6B in total proceeds in the third quarter of 2022. Setting aside the $4.9B in total proceeds from Arm's IPO, the $5.3B in total proceeds for the third quarter of 2023 was still up 107% as compared to the third quarter of 2022.




DATA SOURCE Refinitiv, an LSEG Business

## *U.S. Follow-On Offerings*

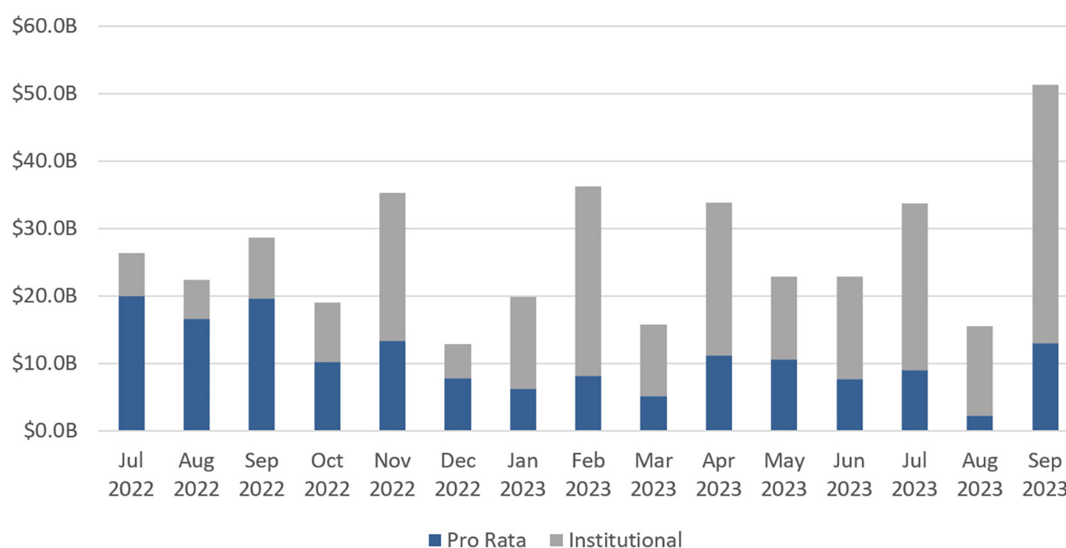
Total proceeds from U.S. follow-on equity offerings declined to $2.6B in July from $11.5B in June, but rose to $7.7B in August and $10.3B in September. The $20.6B in total proceeds from U.S. follow-on equity offerings for the third quarter of 2023 was down 29.6% as compared to $29.2B in total proceeds in the second quarter of 2023 and up 33.3% as compared to $15.4B in total proceeds in the third quarter of 2022.




DATA SOURCE Refinitiv, an LSEG Business

### *U.S. Syndicated Leveraged Loan Issuances*

Activity in the U.S. syndicated leveraged loan market continued to grow in the third quarter of 2023, with total volume up 27% as compared to the second quarter of 2023 and up 30% as compared to the third quarter of 2022. The increase was driven by institutional term loan volume, which spiked to $76.4B in the third quarter of 2023, representing a 52% increase as compared to the second quarter of 2023 and a 261% increase as compared to the third quarter of 2022. By contrast, total pro rata loan volume decreased to $24.2B in the third quarter of 2023, down 18% from $29.4B in the second quarter of 2023 and down 57% from $56.3B in the third quarter of 2022.

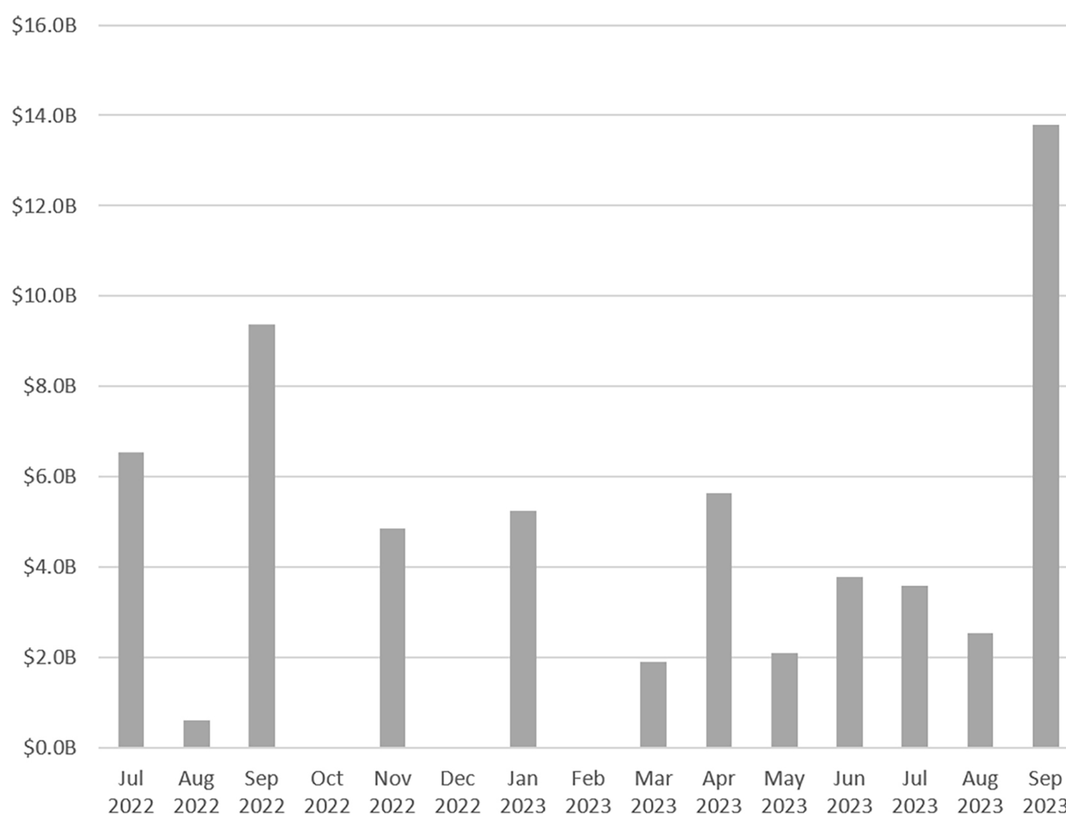



DATA SOURCE Leveraged Commentary & Data (LCD)

## *U.S. Syndicated LBO Loan Volume*

In the third quarter of 2023, there were $19.9B of U.S. syndicated LBO loans issued, representing an increase of 73% as compared to $11.6B in the second quarter of 2023 and an increase of 21% from $16.5B in the third quarter of 2022.

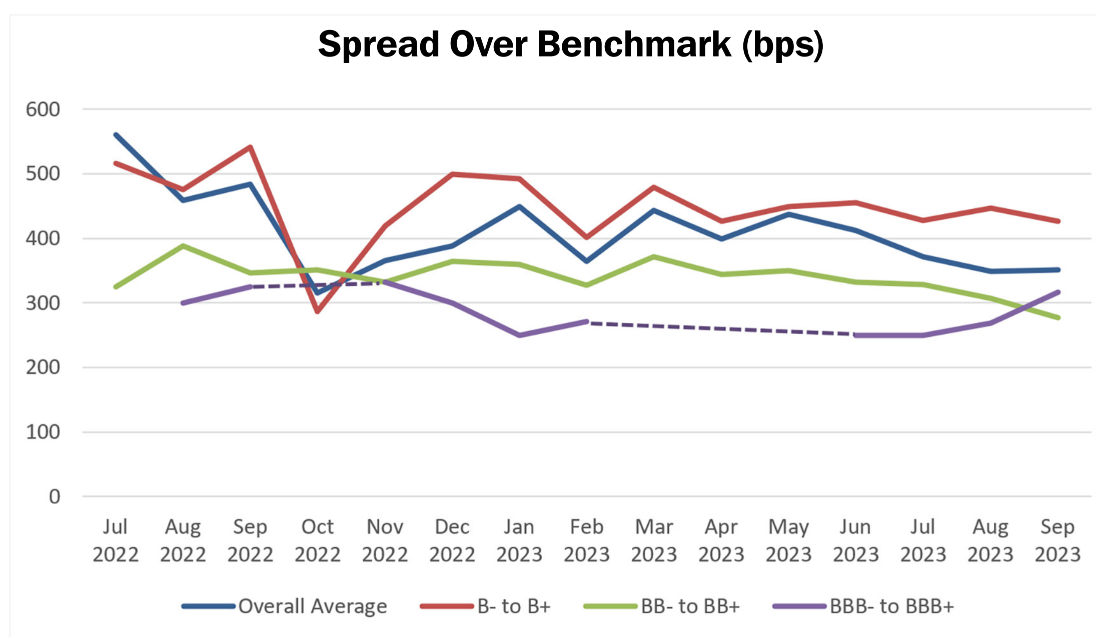
Notably, there were $13.8B of U.S. syndicated LBO loans issued in September, which was the main driver of the increase in volume in the third quarter of 2023.




DATA SOURCE Leveraged Commentary & Data (LCD)

## *Primary Market Syndicated Institutional First-Lien Loan Spreads*

Average spreads over benchmark rates on syndicated first lien institutional loans for large corporate leveraged loan transactions were 356 bps in the third quarter of 2023, which is lower than the 407 bps average spread in the trailing 12-month period. Specifically, average spreads over benchmark rates on syndicated first lien institutional loans to borrowers rated (a) B- to B+ were 433 bps in the third quarter of 2023, which is lower than the 453 bps average spread in the trailing 12-month period, (b) BB- to BB+ were 303 bps in the third quarter of 2023, which is lower than the 349 bps average spread in the trailing 12-month period and (c) BBB- to BBB+ were 278 bps in the third quarter of 2023, which is lower than the 288 bps average spread in the trailing 12-month period.

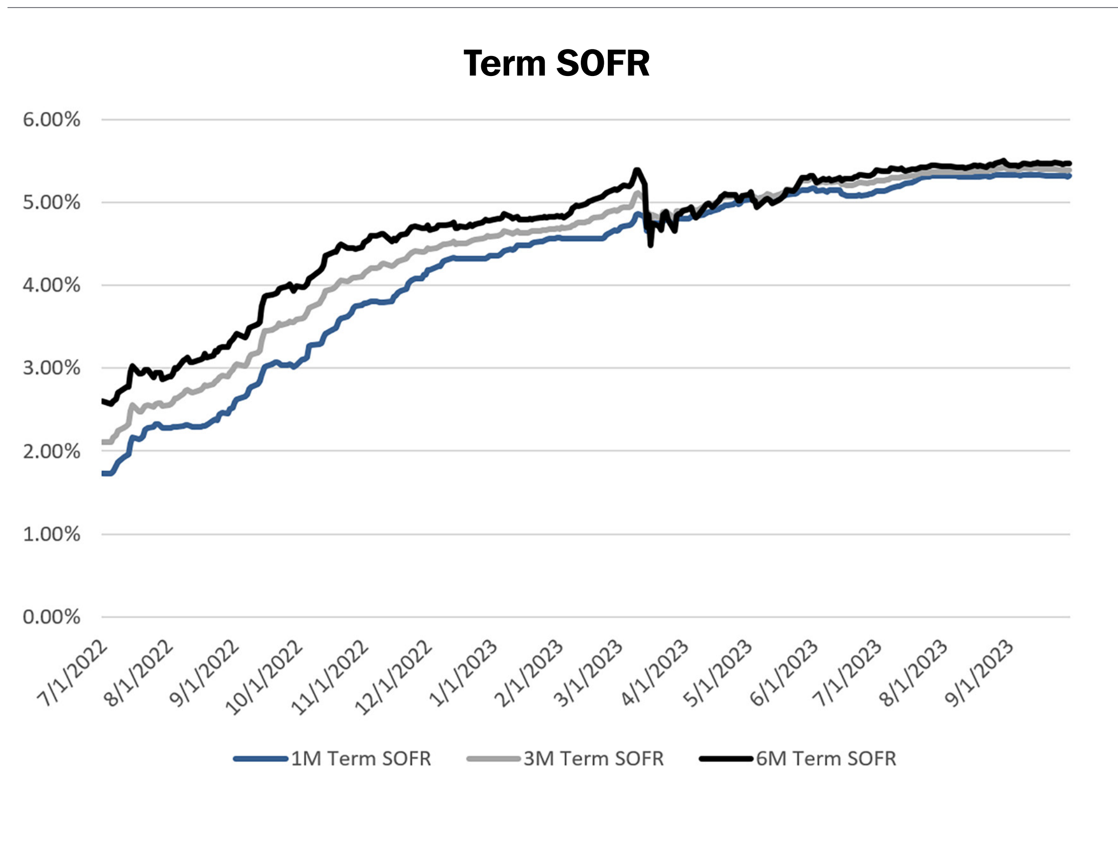



Note: Large corporate borrowers are defined as borrowers with an annual EBITDA of at least $50mm. Average spreads are dollar-weighted based on reported spreads, and do not reflect credit spread adjustments.

DATA SOURCE Leveraged Commentary & Data (LCD)

## *Term SOFR Reference Rate*

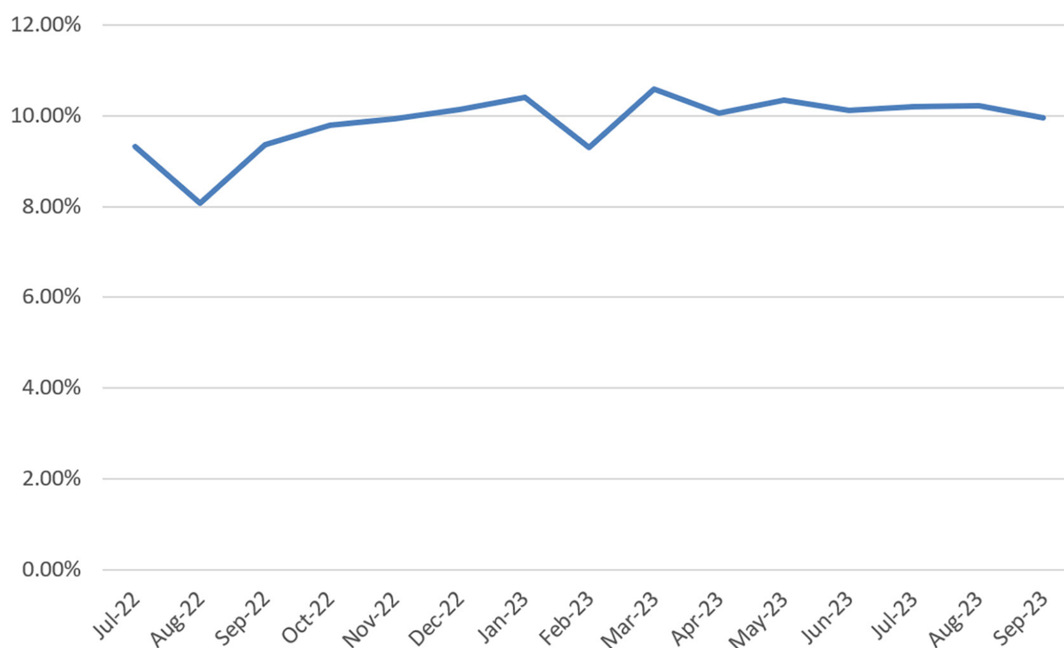
Term SOFR ended the third quarter of 2023 at 5.32%, 5.40% and 5.47% for the one-month, three-month and six-month tenors, respectively, for an increase of 18 bps, 13 bps and 8 bps, respectively, compared to the end of the second quarter of 2023.




DATA SOURCE Bloomberg Finance L.P.

## *Primary Market Syndicated Institutional First-Lien Loan Yields*

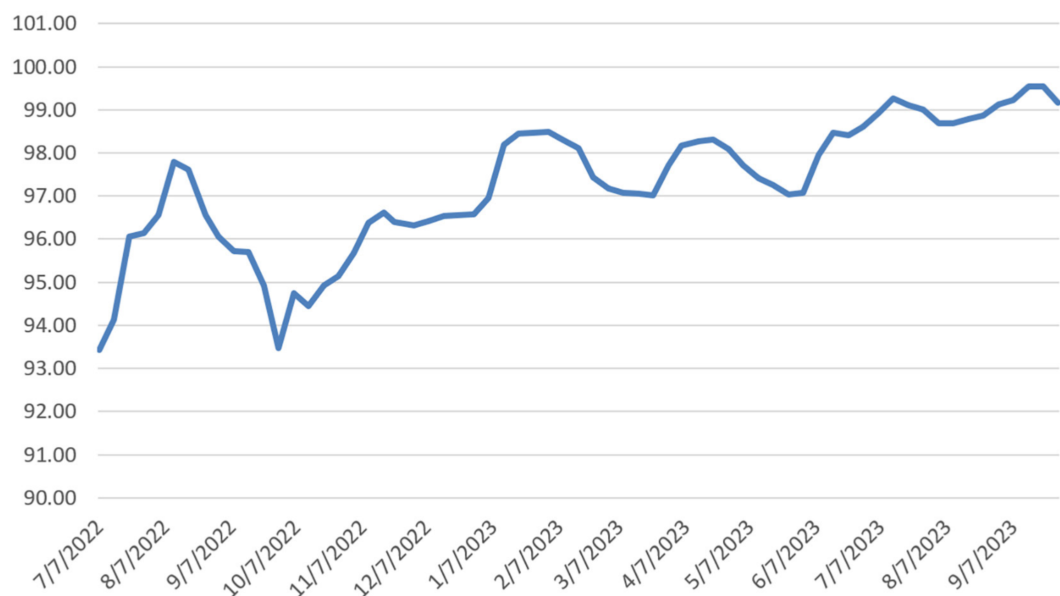
Yields on new-issue syndicated institutional first lien term loans, inclusive of original issue discount, continued to hold steady in the third quarter of 2023. The average yield of 10.12% in the third quarter of 2023 was nearly identical to the average yield of 10.17% in the second quarter of 2023 and the average yield of 10.10% in the first quarter of 2023.




SOURCE Leveraged Commentary & Data (LCD)

## *Secondary Market Pricing*

The average bid price of the LCD Flow Name Index as of the end of the third quarter of 2023 increased by 119 bps as compared to the end of the second quarter of 2023 and increased by 352 bps as compared to the end of the third quarter of 2022.



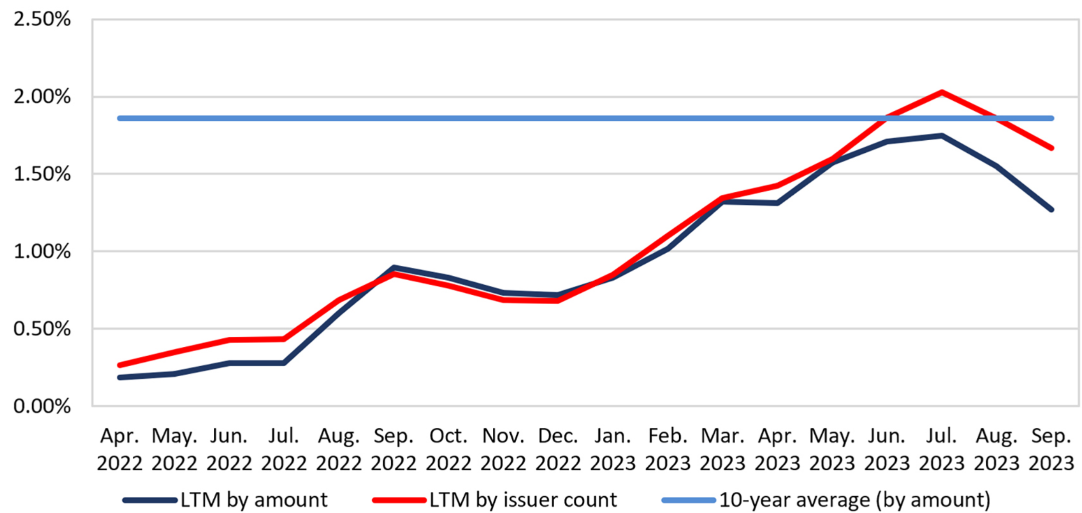

DATA SOURCE Leveraged Commentary & Data (LCD)[1]

1 The LCD Flow Name Index is a composite index of fifteen institutional borrower names published on a twice-weekly basis by Leveraged Commentary & Data (LCD).

RESTRUCTURING

## *U.S. Leveraged Loan Default Rate*

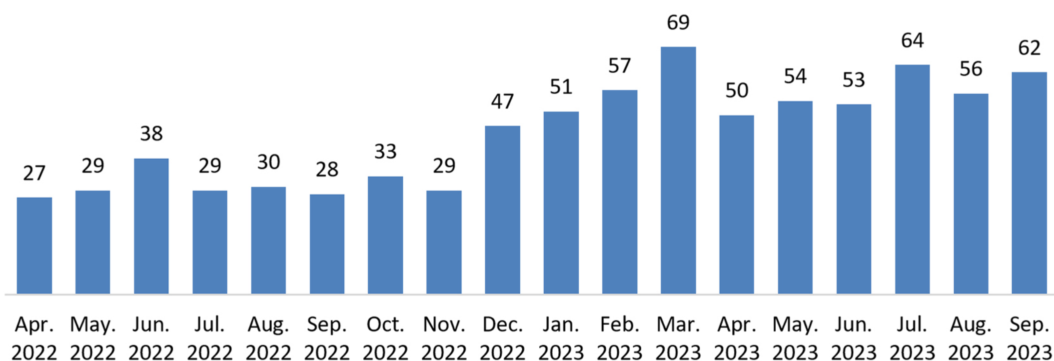
The default rate for U.S. leveraged loans fell in the third quarter of 2023. The default rate of the Morningstar LSTA US Leveraged Loan Index was 1.27% by amount and 1.67% by issuer count for the LTM period ending September 30, 2023, compared to 1.71% by amount and 1.86% by issuer count for the LTM period ending June 30, 2023. As reflected on the following chart, default rates by both amount and issuer count fell below the 10-year average default rate (by amount).




DATA SOURCE PitchBook | Leveraged Commentary & Data (LCD); Morningstar LSTA U.S. Leveraged Loan Index

*U.S. Bankruptcy Filings*

The number of U.S. bankruptcy filings showed no signs of slowing in the third quarter of 2023. Healthcare, consumer discretionary and industrials have continued to set the pace for bankruptcies in 2023, with 12 healthcare bankruptcy filings in September compared to seven bankruptcies in the consumer discretionary sector and six bankruptcies in industrials.




Note: Bankruptcy filing data limited to public companies or private companies with public debt where either assets or liabilities at the time of the bankruptcy filing are greater than or equal to $2 million, or private companies where either assets or liabilities at the time of the bankruptcy filing are greater than or equal to $10 million.

DATA SOURCE S&P Global Market Intelligence

# Regulatory Updates

## *SEC Adopts Cybersecurity Disclosure Rules for Public Companies*

On July 26, 2023, the Securities and Exchange Commission (the "SEC") adopted final rules regarding disclosure by public companies, including foreign private issuers ("FPIs"), of cybersecurity risk management, strategy, governance and related incidents. In particular, the final rules require: (i) current reporting of material cybersecurity incidents; and (ii) annual reporting of companies' processes to identify, assess and manage cybersecurity risks, as well as management's role in assessing and managing, and the board's role in overseeing, such risks.

The final rules will require registrants to disclose on Item 1.05 of Form 8-K any cybersecurity incident they determine to be material and to describe the material aspects of the incident's nature, scope and timing, as well as its material impact or reasonably likely material impact on the registrant. The Form 8-K will generally be due four business days after a registrant determines that a cybersecurity incident is material (rather than the date on which the incident occurred or was discovered). The disclosure may be delayed if the United States Attorney General determines that an immediate disclosure would pose a substantial risk to national security or public safety.

The SEC also adopted new requirements applicable to public companies' annual reports on Form 10-K (not quarterly reports or proxy statements) in Item 106 of Regulation S-K. Under Item 106(b), public companies must describe their processes, if any, for assessing, identifying and managing material risks from cybersecurity threats. In addition, companies must describe whether and how any risks from cybersecurity threats, including as a result of previous cybersecurity incidents, have materially affected or are reasonably likely to materially affect their business strategy, results of operations or financial condition. Under Item 106(c), companies must also describe the board's oversight of risks posed by cybersecurity threats and, if applicable, identify any board committee or subcommittee responsible for the oversight of such risks and describe the processes by which the board (or relevant committee) is informed about such risks. Further, companies must describe management's role in assessing and managing material risks posed by cybersecurity threats. The final rules require comparable disclosures by FPIs on Form 20-F for cybersecurity risk management, strategy and governance.

Regarding the annual reporting requirements on Forms 10-K and 20-F, all companies must begin providing the applicable disclosures in annual reports for fiscal years ending on or after December 15, 2023. With respect to the current reporting requirements on Forms 8-K and 6-K, all companies other than smaller reporting companies must begin complying on or after December 18, 2023. For more information on the cybersecurity disclosure rules, our memorandum describing this matter in more detail is available here.

## *SEC Issues Final Rules Implementing Private Fund Reform*

On August 23, 2023, the SEC adopted new rules and rule amendments under the Investment Advisers Act of 1940 ("Advisers Act") to increase transparency, competition and efficiency in the private funds industry. Under the new rules, registered private fund advisers must (i) provide investors with quarterly statements disclosing fund performance, investment costs, fund expenses and adviser fees (the "Quarterly Statement Rule"); (ii) require the private funds they advise to obtain an annual financial statement audit (the "Private Fund Audit Rule"); (iii) obtain a fairness opinion or valuation opinion for adviser-led secondary transactions (the "Adviser-Led Secondaries

Rule"); and (iv) facilitate the SEC's ability to assess the adviser's compliance with the amended books and records rule under the Advisers Act (the "Books and Records Rule Amendments").

Additionally, the amendments prohibit all private fund advisers, registered or unregistered, from (i) engaging in practices that are contrary to the public interest and the protection of investors unless they provide certain disclosures and, in some cases, receive investor consent (the "Restricted Activities Rule"); and (ii) providing certain preferential treatment to some investors that would cause material negative effects to other investors, unless such preferential treatment is disclosed to all investors (the "Preferential Treatment Rule"). Lastly, all registered advisers, including those who do not advise private funds, must document in writing the annual review of their compliance policies and procedures (the "Compliance Rule Amendments").

The new rules were published in the Federal Register on September 14, 2023 (the "Publication Date") and will become effective on November 13, 2023. The compliance dates will be March 14, 2025 (18 months after the Publication Date) for the Quarterly Statement Rule and Private Fund Rule; September 14, 2024 (12 months after the Publication Date) for advisers with more than $1.5 billion in private fund assets and March 14, 2025 (18 months after the Publication Date) for advisers with less than $1.5 billion in private fund assets, with respect to the Adviser-Led Secondaries Rule, Preferential Treatment Rule and Restricted Activities Rule (subject to certain legacy status exemptions from the Restricted Activities Rule and Preferential Treatment Rule); and November 13, 2023 (60 days after the Publication Date) for the Compliance Rule Amendments.

After the private fund rules were adopted, a coalition of trade groups sued the SEC to challenge the rules in the United States Court of Appeals for the Fifth Circuit ("Fifth Circuit") on September 1, 2023, arguing that the SEC lacks statutory authority to regulate the private funds industry and alleging that it failed to comply with notice-and-comment requirements. On September 27, 2023, the Fifth Circuit granted the plaintiffs' motion to expedite the case and is expected to issue a decision in summer 2024.

## *SEC Adopts Money Market Amendments*

On July 12, 2023, the SEC adopted amendments under the Investment Company Act of 1940 on liquidity and redemption rules for money market funds. With respect to liquidity, the amendments will increase the minimum liquidity requirement from 10% to 25% of a fund's daily liquid assets and from 30% to 50% of a fund's weekly liquid assets. Moreover, liquidity fees will be required under certain conditions. Institutional prime and institutional tax-exempt money market funds will be required to impose a *mandatory* liquidity fee when a fund's daily net redemptions exceed 5% of net assets, subject to a de minimis exception; non-government money market funds will be required to impose a *discretionary* liquidity fee if its board determines the fee to be in the fund's best interest. With respect to redemption, the amendments will eliminate provisions that allow funds to (i) suspend redemption temporarily in the event of rapid redemptions and (ii) impose liquidity fees if a fund's weekly liquid assets fall below a certain threshold. Relatedly, the amendments will modify certain reporting requirements under Form PF with respect to money market funds and large liquidity fund advisers.

The money market rule amendments were published in the Federal Register on August 3, 2023 and became effective on October 2, 2023. Funds will have until April 2, 2024 (six months after the effective date of the final amendments) for compliance with the minimum liquidity requirement and discretionary liquidity fee requirement and October 2, 2024 (12 months after the effective

date of the final amendments) for compliance with the mandatory liquidity fee provision. The amended Form PF requirements will become effective on June 11, 2024.

## Litigation Developments

### *Kirschner v. JPMorgan Chase Bank, N.A.*

On August 24, 2023, the United States Court of Appeals for the Second Circuit (the "Second Circuit"), by a three-judge panel, issued a unanimous decision upholding the district court's ruling that syndicated term loans are not "securities" and are therefore not subject to state and federal securities laws and regulations. As discussed in the Q1 2023 edition of this newsletter, the claim arose from the bankruptcy of Millennium Laboratories LLC ("Millennium"), a private laboratory services company, in which the plaintiff, as trustee of the Millennium Lender Claim Trust, sued the banks that arranged a $1.775 billion syndicated Term Loan B for Millennium.

The credit agreement governing the Term Loan B included a customary provision that permitted lenders to request short-form promissory notes ("Notes") to be issued to further evidence their loans. As part of the bankruptcy proceedings, the plaintiff was appointed trustee of the Millennium Lender Claim Trust, whose beneficiaries were lenders who purchased such "Notes" and had claims in the bankruptcy proceedings. The plaintiff filed suit in 2017 against the banks that arranged the syndication of Millennium's loan (the "defendants") in the U.S. District Court for the Southern District of New York ("SDNY") alleging that such "Notes" were securities under state blue sky laws and that the arranger banks had violated such state securities laws by fraudulently selling debt obligations to approximately 70 institutional investors and, in the process, making material misstatements and omissions to such investors.

On May 22, 2020, the SDNY district court granted the defendants' motion to dismiss and held that the term loans sold to lenders were not "securities". SDNY Judge Paul Gardephe applied the four-factor "family resemblance" test set forth in the U.S. Supreme Court's *Reves v. Ernst & Young* decision, and concluded that the limited number of highly sophisticated purchasers of the loans would not have reasonably classified them as "securities" and that it would have been reasonable for such sophisticated purchasers to believe that they were lending money, with all of the associated risks, without the disclosure and other protections associated with the issuance of securities.

On October 28, 2021, the plaintiff appealed the district court's decision to the Second Circuit. The Second Circuit, applying the *Reves* test, ultimately affirmed SDNY's decision to dismiss the plaintiff's state securities law claims. In particular, the Second Circuit's decision included an analysis of the four *Reves* factors:

1. The Motivations of the Parties: The court first considered the motivations that would prompt a reasonable seller and purchaser to enter into such transaction and decided that this factor weighed *in favor* of concluding that the "Notes" are securities. The court noted that the parties' motivations were mixed: on one hand, Millennium's motivations for selling the instruments were "commercial" because the company was not using the funds to invest in new businesses. On the other hand, because the lenders "expected to profit from their purchase" and the lenders were entitled to "valuable return" in the form of quarterly interest payments, the motivations of the lenders, as purchasers, were for "investment". Ultimately, the court determined that this first factor tilted in favor of concluding that the "Notes" are securities because of the parties' mixed motivations.
2. The Plan of Distribution: The court then examined the plan of distribution to determine

whether the "Notes" are instruments in which there is common trading for speculation or investment, and decided that this factor weighed *against* concluding that the "Notes" are securities. The court noted that the "Notes" were only sold to sophisticated institutional purchasers, and there were strict restrictions on their assignment that rendered them unavailable to the general public, and determined that this factor weighed firmly against concluding that the "Notes" are securities.

3. The Public's Reasonable Perceptions: In this third factor, the court examined the reasonable expectations of the investing public, including whether purchasers are given ample notice that the instruments were loans and not investments in a business enterprise. The court was persuaded by two facts in particular: (a) the lenders' certifications in the loan documentation that they were sophisticated parties that independently made their own appraisal and investigation into the condition and creditworthiness of Millennium in their decisions to make the loans and (b) the loan documentation consistently referred to the purchasers as "lenders". Although there were isolated references to the purchasers as "investors", the court concluded that such isolated references could not have plausibly created the reasonable expectation that the purchasers were investing in securities.

4. Other Risk-Reducing Factors: For this fourth and final factor, the court considered whether some other factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument at issue and renders the application of securities law protection unnecessary. The court determined that this factor firmly weighed *against* the "Notes" being securities, because they are secured by collateral and various federal regulators have specific policy guidance addressing syndicated loans.

The Second Circuit's decision came as a relief to the various participants in the syndicated loan market, as a ruling that syndicated term loans *are* securities, and therefore subject to state and federal securities laws and regulations, would have had dramatic and far-reaching effects on the $1.4 trillion syndicated loan market. Despite the decision, public commentary suggests that some regulators believe that the syndicated loan market requires additional regulation to bolster investor protection and mitigate systemic risks. We will continue to monitor any additional regulatory developments in this space.

The plaintiff is entitled to file a petition for certiorari for review of the Second Circuit's decision by the U.S. Supreme Court for 90 days from the entry of judgment.

## *U.S. Supreme Court Grants Certiorari To Determine Whether the SEC's In-House Enforcement Proceedings Violate the Constitution*

On June 30, 2023, the Supreme Court of the United States granted certiorari to review the Fifth Circuit's 2022 ruling in *Jarkesy and Patriot28, L.L.C. v. SEC*, which held that the SEC's in-house enforcement proceedings violate the Seventh Amendment right to a civil jury and that Congress unconstitutionally delegated legislative power to the SEC by permitting the SEC to determine whether to bring actions in its in-house court or in a federal court.

Petitioner George Jarkesy created two hedge funds and selected Patriot28, L.L.C. ("Patriot 28") as the investment adviser. In 2011, the SEC launched an investigation into Jarkesy and Patriot28 and some years later brought an action within the agency, alleging they had committed fraud under the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act") and the Advisers Act by misrepresenting who served as the prime broker and as the auditor, misrepresenting the hedge funds' investment parameters and safeguards, and overvaluing the assets to

increase fees charged to investors. The SEC's administrative law judge ("ALJ") held an evidentiary hearing and concluded that Jarkesy and Patriot28 committed several forms of securities fraud.

In 2022, the Fifth Circuit reviewed and sided with Jarkesy and Patriot28 on the constitutionality of the SEC's enforcement authority. It held the following:

1. Jarkesy and Patriot28 were deprived of their Seventh Amendment right to a jury trial because the SEC's enforcement action is similar to traditional actions at law to which the jury-trial right attaches, even though some of the actions brought and the remedies ordered by the SEC were equitable. Neither Congress nor an agency acting pursuant to congressional authorization can assign the adjudication of such claims to an agency because such claims do not solely pertain to "public rights" (*i.e.*, rights created by Congressional statute that are so closely integrated with a regulatory scheme that they are fit to be resolved by an administrative agency).
2. The decision to assign actions to agency adjudication is uniquely Congressional. Congress unconstitutionally delegated legislative power to the SEC by giving it unqualified authority to choose whether to bring enforcement actions in federal courts or within the agency. Congress failed to provide the SEC with an intelligible principle by which to exercise the delegated power.
3. Statutory removal restrictions on SEC ALJs violate Article II of the Constitution. SEC ALJs perform substantial executive functions. As such, the President must have sufficient control over their performance, which includes the ability to remove ALJs. ALJs are unconstitutionally insulated from removal by the President by a two-layer process: (i) ALJs can only be removed by the SEC Commissioners if good cause is found by the Merits Systems Protection Board ("MSPB") and (ii) SEC Commissioners and MSPB members can only be removed by the President for cause.

The U.S. Supreme Court is set to hear arguments on this ruling and is expected to issue its decision in summer 2024.

### *U.S. Supreme Court To Resolve Circuit Split on Whether MD&A Can Be the Basis for Securities-Fraud Liability*

Item 303 of Regulation S-K requires that a company disclose certain information "where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial conditions or results of operations". Companies must disclose this information in the Management's Discussion and Analysis section of their annual report and in other filings with the SEC. On September 29, 2023, the U.S. Supreme Court agreed to review the decision by the Second Circuit in *Moab Partners L.P. v. Macquarie Infrastructure Corp.*, which held that public companies may be liable under Section 10(b) of the Exchange Act and Rule 10b-5 through private causes of action for failure to disclose information required by Item 303. In contrast, the Ninth and Eleventh Circuits have held that omitting a trend or uncertainty required by Item 303 is not necessarily a violation of Section 10(b). The U.S. Supreme Court's decision could resolve this circuit split. The Court will likely hear arguments on this case in early 2024, with its decision expected in summer 2024.

### *Manufacturer Organizations Sue SEC over Rule 15c2-11 Private Business Financial Disclosure*

In *National Association of Manufacturers v. SEC*, trade groups National Association of Manufacturers and Kentucky Association of Manufacturers sued the SEC over its new interpretation applying Rule 15c2-11 to Rule 144A fixed-income securities.

In 1971, Rule 15c2-11 was promulgated with the aim of providing investors with sufficient information to trade over-the-counter stocks. As discussed in the Q4 2022 edition of this newsletter, the rule was amended in 2020, and the SEC issued a series of no-action letters in 2021 interpreting the amendment as applying Rule 15c2-11 disclosure requirements to debt securities trading on the secondary market. In the wake of these letters, private companies will be required to publicly disclose detailed financial information to facilitate secondary market trading of their debt securities.

On September 12, 2023, the National Association of Manufacturers and Kentucky Association of Manufacturers filed suit against the SEC in the U.S. District Court for the Eastern District of Kentucky. The manufacturer organizations argue that the SEC's no-action letters were an unprecedented move to expand Rule 15c2-11 to require financial disclosure from private companies issuing corporate bonds, and that the SEC violated the Administrative Procedure Act by making this change in policy without conducting traditional rulemaking procedures.

In their complaint, the National Association of Manufacturers and Kentucky Association of Manufacturers request that the court enjoin the SEC from enforcing the interpretation that Rule 15c2-11 applies to Rule 144A fixed-income securities at least until the SEC submits a rule amendment for public comment.

### *Massachusetts Court Upholds Fiduciary Duty Rule for Broker-Dealers, with Strict Standard of Care Akin to That of Investment Advisors*

On August 25, 2023, the Supreme Judicial Court of Massachusetts, Massachusetts's top appellate court, held in a unanimous decision that Commonwealth Secretary William Galvin had the authority to promulgate a fiduciary duty rule that holds broker-dealers to the same standards as investment advisors. Investment advisors are designated as fiduciaries by Congress and must act in their client's best interest under the Advisers Act. Broker-dealers, on the other hand, were traditionally intermediaries between buyers and sellers, held to lower standards. Secretary Galvin argued that the lines between investment advisors and broker-dealers have been blurred over time, warranting this new rule imposing a strict standard of care. The Supreme Judicial Court found that the Massachusetts Uniform Securities Act authorized Secretary Galvin to provide this additional protection to investors. Several other states' courts (*e.g.*, in California, Missouri and South Carolina) have enforced or imposed fiduciary duty standards on broker-dealers, and other states such as New Jersey and Nevada have proposed doing so (though New Jersey has since withdrawn).

## Restructuring Updates

### *Default Interest in Bankruptcy: In re: Golden Seahorse LLC*

On July 31, 2023, in the case of *In re: Golden Seahorse LLC, d/b/a Holiday Inn Manhattan Financial District*, Judge Philip Bentley of the U.S. Bankruptcy Court for the Southern District of New York ruled that a debtor must pay default interest resulting from a payment default if it

wishes to reinstate its pre-petition low-interest-rate debt.

Debtor Golden Seahorse, the owner of a Holiday Inn in downtown Manhattan, borrowed $137 million at a fixed rate of 5.259% under a 10-year mortgage in September 2018. In May 2020, when the hotel closed due to the pandemic, the Debtor defaulted when it failed to make the required monthly payments. The lenders subsequently accelerated the loan, began to charge interest at the contractual default rate (an additional 5%) and had a receiver appointed in state court. Prior to the receiver seizing the hotel, Golden Seahorse filed voluntary chapter 11 petitions in U.S. Bankruptcy Court for the Southern District of New York.

As part of its chapter 11 plan, the Debtor sought to reinstate the mortgage and treat it as unimpaired under section 1124(2) of the Bankruptcy Code without paying the default interest and fees that had accrued following its default. Prior to scheduling a vote on the plan confirmation, both the Debtor and the lenders asked Judge Bentley to rule on the issue of whether the Debtor was required to pay approximately $20 million of default interest and fees as a condition of reinstatement.

In resolving the question put to him, Judge Bentley closely examined three interrelated provisions of the Bankruptcy Code, sections 365(b)(2)(D), 1123(d) and 1124(2), concluding that:

1. sections 1124(2) and 365(b)(2)(D) of the Bankruptcy Code create an exception for the satisfaction of any default penalty under an executory contract or unexpired lease to section 1123(d)'s otherwise absolute mandate requiring payment of all cure amounts required by the parties' agreement and permitted by non-bankruptcy law, including default interest; and
2. section 365(b)(2)(D)'s cure carve-out, as incorporated by section 1124(2)(A), applies to loan agreements; but
3. section 365(b)(2)(D)'s cure carveout extends only to penalty rates triggered by non-monetary defaults.

Therefore, when the debtor's default arises from its failure to perform monetary obligations, as it does here, the debtor must pay default interest to the extent provided by its agreement and permitted by non-bankruptcy law in order to reinstate its defaulted debt under section 1124(2). However, if the debtor's default arises from failure to perform non-monetary obligations, the cure exception in section 365(b)(2)(D) applies and payment of the default interest is not required.

This issue—whether reinstatement of defaulted and accelerated debt requires payment of default-rate interest and fees—is particularly important in today's environment, in which many borrowers have financing arrangements in place at much lower rates than could be obtained under current market conditions. The Debtor filed an appeal to Judge Bentley's decision, and Judge Bentley certified the matter for direct appeal to the Second Circuit.

### *Section 363 Sales and Collective Bargaining Obligations: In re: CCX, Inc.*

On September 18, 2023, Judge Gregory B. Williams of the U.S. District Court for the District of Delaware issued an opinion holding that a "free-and-clear" sale approved pursuant to section 363 of the Bankruptcy Code could not insulate a buyer from its post-closing obligations under the National Labor Relations Act of 1935 ("NLRA") to bargain with a union, even where the Bankruptcy Court found that the buyer was not a successor to the seller and the underlying collective bargaining agreement ("CBA") had been rejected by the seller.

Debtor CCX was a specialty steel manufacturer operating a factory in Pennsylvania, where it employed workers represented by the United Steelworkers ("USW") under a CBA. CCX filed a bankruptcy petition in March 2022, and conducted a sale process in which Braeburn Alloy Steel LLC was the winning bidder. In connection with the sale, Braeburn declined to assume the CBA with USW. The Bankruptcy Court entered a sale order approving the sale under section 363 of the Bankruptcy Code, providing that Braeburn would acquire substantially all of CCX's assets free and clear of "any rights or claims based on . . . successor or transferee liability", and that Braeburn would not be deemed to be a successor of CCX.

Following closing of the section 363 sale, Braeburn provided employment offers to substantially all of CCX's former employees under new terms and conditions of employment. The same day that the sale closed, USW requested that Braeburn recognize USW as the collective bargaining representative of its employees, as under the NLRA, a new employer continuing the "employing industry" and employing a majority of its employees from the workforce of the predecessor employer is a "successor" bound to recognize and bargain with the union. In other words, even though the bankruptcy sale order specifically provided that Braeburn was not a "successor", the USW argued that it was a "successor" under the NLRB (a federal statute like the Bankruptcy Code). Braeburn refused to recognize USW, and following USW's pursuit of relief with the NLRB, Braeburn filed a motion with the Bankruptcy Court to enforce the sale order. The Bankruptcy Court issued a bench ruling in favor of Braeburn that USW had consented to the sale free and clear of the CBA under section 363(f) of the Bankruptcy Code by virtue of its participation in the sale hearing and its failure to raise an objection, and USW appealed the ruling to the U.S. District Court for the District of Delaware.

Judge Williams of the U.S. District Court of Delaware reversed the Bankruptcy Court, holding that while a "free-and-clear" purchase under section 363 of the Bankruptcy Code may extinguish obligations incurred prior to the sale of the debtor's assets, it cannot insulate a buyer from obligations arising after the sale due to the buyer's own conduct. In his decision, Judge Williams focused on the fact that, following the sale, Braeburn had voluntarily elected to hire the employees, which brought Braeburn under the purview of the NLRB, regardless of whether Braeburn believed that it disclaimed successor obligations in connection with the sale. The District Court held that the obligation to recognize USW as the exclusive bargaining representative was not an interest in property that could be extinguished by virtue of section 363(f) of the Bankruptcy Code, as it existed independently of the CBA as a statutory obligation under a co-equal federal law.

This case illustrates a limitation to the clean slate that section 363 sales can provide. Although the protections in a sale order can shield a buyer from claims and obligations arising from the pre-sale conduct of the debtor, a section 363 sale order may not provide a shield against all post-sale obligations, particularly when another federal statute is involved (environmental law, labor law, etc.).

## Other Developments

### *SEC Issues Five CDIs on Rule 10b5-1 Amendments*

On August 25, 2023, the SEC's Division of Corporation Finance issued five Compliance and Disclosure Interpretations ("CDIs") to provide guidance for the 2022 Rule 10b5-1 amendments and disclosure requirements. Three of the CDIs (Questions 120.29–120.31) address the Rule 10b5-1 amendments and clarify the cooling-off

period, 401(k) plans and Form 4 checkbox requirements. The other two CDIs (Questions 133A.01–133A.02) relate to disclosure requirements under Item 408(a) of Regulation S-K and address issues regarding disclosure of plan expirations and trading by a director or officer. For more information, the CDIs are available here.

CDI Question 120.29 pertains to the required cooling-off period[2] under Rule 10b5-1, which can be the later of (subject to a maximum period of 120 days after the trading plan was adopted) 90 days after a trading plan was adopted or two business days following the filing of the first Form 10-Q or Form 10-K after the plan was adopted (with the first business day being the business day following the filing date of the Form 10-Q or Form 10-K, rather than the filing date).

CDI Question 120.30 provides that an open market transaction made under a 401(k) plan at the direction of a plan administrator, and not the plan participant, to match a 401(k) contribution with employer stock would not be deemed an overlapping plan and therefore would not disqualify participants from the Rule 10b5-1 affirmative defense.

CDI Question 120.31 notes that the Rule 10b5-1 checkbox on Form 4 for securities transactions does not apply to trading plans that were adopted prior to the effective date of the Rule 10b5-1 amendments.

CDI Question 133A.01 provides that under Item 408(a)(1), disclosure of a plan termination is not required for a plan that ends due to its expiration and completion.

CDI Question 133A.02 clarifies that Item 408(a) requirements apply to both Rule 10b5-1 and non-Rule 10b5-1 trading plans covering securities in which an officer or director has a pecuniary interest.

### *SEC Announces First Fee Rate Advisory for FY 2024*

On August 25, 2023, the SEC announced a fee increase for the registration of securities from $110.20 per million dollars to $147.60 per million dollars for public companies and other issuers. The new fee rate became effective on October 1, 2023.

### *Senate Approves Legislation To Nullify Section 16 Exemption for FPIs*

On July 27, 2023, the Senate voted to approve the National Defense Authorization Act for Fiscal Year 2024 ("NDAA"), which contains a provision that would extend Section 16 of the Exchange Act to insiders of foreign private issuers. Section 16 requires insiders of a U.S.-listed company to report transactions in company securities to the SEC. Moreover, Section 16 also imposes liability on insiders for gaining short-swing profits from engaging in certain transactions. Previously, FPIs were exempt from the disclosure and short-swing liability provisions of Section 16 under an exemption in Rule 3a12-3. If enacted into law, this amendment would nullify Rule 3a12-3 and subject FPIs to insider disclosure requirements and open the door to liability for short-swing profits. However, the House of Representatives passed their version of the NDAA on July 14, 2023, which did not contain any reference to Section 16 of the Exchange Act.

### *NYSE Proposes Removing Shareholder Approval Requirement for Capital Raising from Non-Controlling Shareholders*

On September 29, 2023, the SEC published notice and request for comment on the New York Stock Exchange's ("NYSE") proposal to amend

2 The Rule 10b5-1 amendments require, among other conditions, Rule 10b5-1 plans to include a cooling-off period in order to rely on the affirmative defense.

Section 312.03(b) of the NYSE Listed Company Manual ("Manual") to allow listed companies to issue shares below the Minimum Price (*i.e.*, the lower of (a) the official closing price and (b) the average official closing price for the five trading days, in each case, immediately before the signing of the binding agreement) to passive shareholders (who are not part of a control group) without shareholder approval. Section 312.03(b)(i) of the Manual requires shareholder approval prior to the issuance of common stock (or securities convertible into / exercisable for common stock) to a director, officer or substantial security holder (holders with 5% or more of the common stock or of the voting power outstanding) of the company if the number of shares of common stock to be issued (or into which the securities may be converted or exercised) exceeds either 1% of the number of shares of common stock or 1% of the voting power outstanding before the issuance. The Manual provides an exception to the shareholder approval requirement for cash sales, but only to the extent they are not below the Minimum Price.

NYSE proposes to limit the application of Section 312.03(b)(i) to sales to directors, officers, controlling shareholders or members of a control group or any other substantial security holder that has an affiliate who is an officer or director.

### *SEC Issues Charges for Misleading Investors About Revenue Projections Ahead of SPAC Merger*

On September 28, 2023, the SEC charged Spruce Power Holding Corporation ("Spruce Power"), the successor to XL Fleet Corp. ("XL Fleet"), for misleading investors about revenue projections. In 2020, XL Fleet, which provided hybrid electric vehicle systems for commercial fleet vehicles, went public through a merger with a SPAC. XL Fleet disclosed in previous filings its $75 million near-term revenue projections and up to $1.4 billion longer-term projections, as well as claims of an over $220 million 12-month sales pipeline. The SEC's order finds that the projections were misleading because the sales pipeline consisted almost entirely of speculative opportunities, which included sales to customers to whom they could not legally sell, potential customers with whom they had little or no contact and stale sales opportunities that had not been updated in the company's systems. The order found that the company violated certain antifraud, proxy and reporting provisions of the federal securities laws. Spruce Power consented to a cease-and-desist order and a civil penalty of $11 million (without admitting or denying the order's findings).

## Crypto Updates

### *SDNY Determines Whether Cryptocurrencies Are Securities*

In July 2023, SDNY ruled on two SEC enforcement actions against cryptocurrency issuers Ripple Labs, Inc. ("Ripple") and Terraform Labs Pte. Ltd. ("Terraform"). Among others, the SEC alleged that defendants engaged in the offer and sale of unregistered securities in violation of Section 5 of the Securities Act. In both cases, SDNY judges wrestled with the core issue facing crypto-enforcement—whether cryptocurrencies are securities. In *SEC v. Ripple Labs, Inc.*, Judge Analisa Torres found that XRP tokens are a security when distributed through institutional sales but are not a security when distributed through programmatic sales made to retail buyers, granting partial victory to both the SEC and the defendants in cross-motions for summary judgment. Two weeks later, in *SEC v. Terraform Labs Pte. Ltd.*, Judge Jed Rakoff explicitly rejected the approach in *Ripple* and ruled in favor of the SEC on motion to dismiss, finding that the SEC asserted a plausible claim that sales of Terraform's crypto assets are securities offerings.

In both cases, the courts determined whether the applicable crypto assets qualify as "investment contracts" under *SEC v. W.J. Howey Co.*, the seminal case creating a three-prong test to define a security. *Howey* holds that the sale of certain assets would qualify as an investment contract or a security if the buyer (i) invests money, (ii) in a common enterprise and (iii) reasonably expects to receive profits derived from the entrepreneurial or managerial efforts of others.

The first two prongs of *Howey* were easily met in each case. On the third prong, the *Ripple* court found that institutional buyers purchased XRP tokens with the expectation of profits, since Ripple made public statements that would lead reasonable investors to believe that proceeds will be used to cultivate the market and value of XRP tokens. In contrast, retail buyers purchased tokens in blind bid/ask transactions on digital asset exchanges and therefore did not expect future returns to be derived from the efforts of Ripple. In *Terraform*, Judge Rakoff ruled in favor of the SEC, taking all allegations to be true at the motion-to-dismiss stage, and found that the sale of Terraform's digital assets were marketed as investments promising growth potential tied to the Terraform blockchain ecosystem. Despite reaching different conclusions, both judges relied on promotional materials and public communications to determine the basis for investor expectations in the issuer's efforts to generate investment returns.

## *SEC Brings and Settles Two NFT Enforcement Actions*

The SEC settled enforcement actions with Impact Theory, LLC ("Impact Theory") and Stoner Cats 2, LLC ("SC2"), each for unregistered sale of securities in the form of NFTs in violation of Sections 5(a) and 5(c) of the Securities Act.

Impact Theory allegedly sold KeyNFTs to at least hundreds of investors across multiple states raising $29,896,237.16 worth of ether, allowed the KeyNFTs to be sold on two secondary market platforms and programmed the smart contract to include a 10% royalty to Impact Theory for each secondary market sale. Impact Theory settled with the SEC without admitting or denying the SEC's findings. Remedial efforts included, among other remedies, repurchasing KeyNFTs on the secondary market; destroying all KeyNFTs in its possession or control; revising smart contracts and other programming codes to remove the royalty for secondary market transactions; paying disgorgement of $5,120,718.27, prejudgment interest of $483,195.90 and a civil money penalty of $500,000; and publishing notice of the SEC's order on their websites and social media.

SC2 allegedly conducted a public offering of NFTs, raising approximately $8.2 million to finance Stoner Cats, an adult animated television show. The NFTs were also sold on the secondary market. Both before and after the public offering, SC2 engaged in an extensive media campaign promoting the NFTs; advertising that owners of NFTs would get exclusive access to Stoner Cats content and the Stoner Cats community on Discord and the option to resell the NFTs on the secondary market; touting SC2's expertise in the media and NFT space; and claiming that the more successful the show is, the more successful the NFTs will be. SC2 settled without admitting or denying the findings and agreed to, among other remedies, destroy all Stoner Cats NFTs in their possession, custody or control, publish notice of the SEC's order on the SC2 website, pay a $1 million civil money penalty and establish a fair fund.

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