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### Temporary Securities Regulation

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Anita K. Krug

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# Temporary Securities Regulation

Anita K. Krug\*

## *Abstract*

*In times of crisis, including during the 2020–2021 global pandemic, the U.S. Securities and Exchange Commission (SEC) has engaged in a type of securities regulation that few scholars have acknowledged, let alone evaluated. Specifically, during recent market crises, the SEC adopted rules that are temporary, designed to help the securities markets and their participants—both public companies and public investment funds, such as mutual funds and ETFs—weather the crisis at hand but go no further. Once that goal has been accomplished, these rules usually expire, replaced by the permanent rules that they temporarily supplanted. Although the temporary-rulemaking endeavor is laudable—and arguably necessary for the sake of maintaining well-functioning markets in times of crisis—neither the SEC nor its observers have sufficiently acknowledged the meaningful risks that temporary rules might present to investors. At the same time, they have not appreciated the opportunities that temporary rules may create for furthering the cause of more effective regulation. This Article seeks to illuminate the potential and the pitfalls of temporary rules, thereby contributing to a better understanding of what is at stake when the SEC adopts them and what considerations should inform the agency’s rulemaking during future crises.*

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## INTRODUCTION

In May 2020, shareholders of the cruise operator Carnival Corporation sued the company and its CEO in federal court, alleging that the company made a number of misstatements in the Form 10-K report it filed in January 2020 regarding the occurrence of COVID-19 among passengers on its cruise ships and its protocols on health and safety.<sup>1</sup> Following this, *Bloomberg Businessweek*'s and the *Wall Street Journal*'s reporting on Carnival's handling of the COVID-19 outbreak was

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1. See Omnibus Order at 2–3, *Serv. Lamp Corp. Profit Sharing Plan v. Carnival Corp.*, No. 1:20-cv-22202 (S.D. Fla. Oct. 30, 2020), ECF No. 42 (describing the contents of Carnival Corporation's January 2020 10-K report and the subsequent news reports placing those contents into question).

critical of the cruise line.<sup>2</sup> Allegedly as a result of these events, the company's stock price declined by 16 percent.<sup>3</sup>

In August 2020, shareholders of STAAR Surgical Co., a company that makes implantable eye lenses, sued the company and its CEO in federal court, alleging that the company made a number of material misrepresentations, including in the Form 10-K report it filed in late February 2020, the Form 8-K it filed in April 2020, and the Form 10-Q report it filed in May 2020, regarding its positive sales outlook and the impact of COVID-19 on its sales performance.<sup>4</sup> These alleged misstatements were followed by the company's August 2020 Form 10-Q filing, in which it stated that financial results for the second quarter were disappointing, and a third-party report stating that fraud pervaded part of the company's business.<sup>5</sup> Allegedly as a result of these events, the company's stock price declined by 16.2 percent.<sup>6</sup>

In September 2020, shareholders of Portland General Electric Co., an electrical utility, sued the company and its CEO in federal court, alleging that the company misrepresented its financial performance for the first quarter of 2020 in its April 2020 Form 10-Q report.<sup>7</sup> Shareholders further alleged that, in

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2. See *id.* at 4 (noting that, in April 2020, the *Wall Street Journal* published an article making allegations about Carnival Corp.'s role in spreading COVID-19 and describing "early warning signs" that Carnival had failed to disclose (internal citations omitted)).

3. See MICHAEL G. BONGIORNO ET AL., WILMERHALE, COVID-19: LESSONS FROM THE SECOND WAVE OF SECURITIES FRAUD CLASS ACTIONS 4 (2020), <https://perma.cc/49VP-A6QR> (PDF) (noting that Carnival Corporation's stock price declined by 4 percent after a business publication stated that the company failed to adequately protect customers and another 12 percent after the *Wall Street Journal* published its article on how the company "facilitated the spread of COVID-19").

4. See Complaint at 7, 11–12, *Alwazzan v. STAAR Surgical Co.*, No. 8:20-cv-01533 (C.D. Cal. Aug. 19, 2020) (detailing the company's misstatements in its required regulatory filings regarding its sales volume).

5. See *id.* at 14–19 (describing the disclosures in the Form 10-Q report and the third-party report).

6. See *id.* at 15, 19 (noting that the company's stock price fell by 10 percent following the 10-Q filing on August 5th and another 6.2 percent following the dissemination of the third-party report on August 11th).

7. See Complaint at 5–8, *Cannataro v. Portland Gen. Elec. Co.*, No. 3:20-CV-01583 (D. Or. Sept. 11, 2020), ECF No. 1 (quoting relevant portions of the company's April 24, 2020, Form 10-Q report and an accompanying press

its July 2020 Form 10-Q report, it understated certain risks associated with its business.<sup>8</sup> The alleged misstatements became evident in August 2020, when the company announced losses and stated that it was lowering its 2020 projections.<sup>9</sup> Allegedly as a result, the company's stock price declined by 11 percent.<sup>10</sup>

Meanwhile, on March 4, 2020, the U.S. Securities and Exchange Commission (SEC) issued a temporary rule providing leniency to public companies in filing their required quarterly Form 10-Q reports, annual Form 10-K reports, and current Form 8-K reports.<sup>11</sup> Specifically, the SEC extended the deadlines for filings otherwise due before May 1, 2020, by forty-five days, provided a filing company met certain conditions.<sup>12</sup> According to the SEC, the basis for the temporary rule was to assist companies grappling with the challenges associated with the COVID-19 pandemic.<sup>13</sup> Under a modified version of the rule dated March 25, 2020, the SEC extended this relief to cover all Form 10-Q, 10-K, and 8-K reports otherwise due prior to July 1, 2020.<sup>14</sup>

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release stating that the company's "financial performance . . . largely reflects conditions experienced prior to the COVID-19 pandemic").

8. *See id.* at 9–12 (quoting relevant portions of the Form 10-Q report, which described positive financial outcomes for the quarter and effective controls and procedures, as well as the content of a press release accompanying the report).

9. *See id.* at 13–14 (quoting relevant portions of the August 24, 2020, press release).

10. *See id.* at 14 (detailing the alleged losses).

11. *See* Order Under Section 36 of the Securities Exchange Act of 1934 Granting Exemptions from Specified Provisions of the Exchange Act and Certain Rules Thereunder, Exchange Act Release No. 88,318, 85 Fed. Reg. 13,680, 13,680 (Mar. 9, 2020) [hereinafter 2020 Disclosure Rule] (setting forth the relief and the conditions associated with a company's reliance on it).

12. *See id.* at 13,680–81.

13. *See id.* at 13,680 (noting that the purpose of the rule was to "assist affected entities with meeting their obligations under the federal securities laws").

14. *See* Order Under Section 36 of the Securities Exchange Act of 1934 Modifying Exemptions from the Reporting and Proxy Delivery Requirements for Public Companies, Exchange Act Release No. 88,465, 85 Fed. Reg. 17,610, 17,610 (Mar. 30, 2020) [hereinafter 2020 Disclosure Rule Extension].

The pandemic presented difficult trade-offs in its early months. Perhaps the most obvious one is that, although implementing measures such as “lockdowns” and temporary business closures was arguably critical for ensuring the population’s health and safety, those protective measures contributed to widespread unemployment and threatened near-term economic growth.<sup>15</sup> There was also a less-obvious trade-off. While the pandemic was creating conditions that promoted incidences of securities fraud and accompanying litigation,<sup>16</sup> the SEC steadily adopted temporary measures to provide relief to public companies and public investment funds to help them comply with their ongoing obligations under the securities laws.

Temporary rules, though rarely (if ever) studied, are not new. They are a regulatory response to national and international crises that present hardships for public companies as well as some private ones.<sup>17</sup> These crises include not only the 2020 pandemic but also the 2007–2009 financial crisis and the 2001–2002 “dot-com” stock market decline and contemporaneous September 11, 2001, terrorist attacks.<sup>18</sup> The temporary rules adopted to date demonstrate that the agency

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15. See Greg Ip, *Economics vs. Epidemiology: Quantifying the Trade-Offs*, WALL ST. J. (Apr. 15, 2020, 9:57 PM), <https://perma.cc/Y8P3-YN5P> (“The rising economic toll of pandemic-induced shutdowns is fueling suspicions that government leaders are listening too much to epidemiologists and not enough to economists.”).

16. See J. Timothy Mast et al., *Operating in a Pandemic: Securities Litigation Risk and Navigating Disclosure Concerns*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 14, 2020), <https://perma.cc/D7FH-SJPM> (“The COVID-19 pandemic has introduced new corporate disclosure issues and increased the attendant risk of securities fraud actions, as evidenced by plaintiffs’ initial filings across the country in the past few weeks.”).

17. See, e.g., KAN. STAT. ANN. § 77-422 (2022)

A rule and regulation may be adopted by a state agency as a temporary rule and regulation if the state agency and the state rules and regulations board finds that the preservation of the public peace, health, safety or welfare necessitates or makes desirable putting such rule and regulation into effect prior to the time it could be put into effect if the agency were to comply with the notice, hearing and publication requirements . . . .

18. See *infra* Part IV.A (describing some of the temporary rules that the SEC adopted to address challenges arising from recent securities market crises).

deems these rules—which typically take the form of “orders” rather than “rules”—necessary in times of crisis to provide either leeway to companies struggling with the demands of ongoing regulatory compliance<sup>19</sup> or protection for companies suffering weakened positions vis-à-vis other market participants.<sup>20</sup> As this description suggests, the purposes of temporary rulemaking may differ from crisis to crisis. Some temporary rules provide leniency to market participants (“leniency rules”), while others apply greater limitations to market participants’ activities to prevent them from harming other participants (“stringency rules”).<sup>21</sup>

The former purpose generally provided the rationale for the SEC’s temporary rulemaking during the pandemic. But as the examples above suggest, temporary rules may have unanticipated adverse effects on the securities markets and investors.<sup>22</sup> More specifically, Forms 10-K and 10-Q—publicly-released annual and quarterly reports, respectively, which are required of public companies under the securities laws—contain information that is important to investors regarding the companies’ operational and financial health.<sup>23</sup> Particularly in the pandemic context, these reports can inform investors about such things as the incidence of COVID-19 among a company’s customers (companies in the travel industry), products the company is developing to combat or prevent COVID-19 (pharmaceutical companies), cybersecurity risks in connection with online meeting platforms (technology companies), and, more generally, the company’s

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19. See *infra* notes 50–67 and accompanying text (describing some of the temporary rules adopted by the SEC during the 2020 pandemic).

20. See *infra* notes 145–161 and accompanying text (describing the temporary rules adopted by the SEC during the 2007–2009 financial crisis).

21. As Part III.A describes, most of the SEC’s temporary rules during the 2020 pandemic and in the aftermath of the September 11, 2001, terrorist attacks could be characterized as leniency rules, while most of those that the agency adopted during the 2007–2009 financial crisis could be characterized as stringency rules.

22. See Mast et al., *supra* note 16 (discussing the potential for increased litigation against publicly held companies due to changes in policies resulting from the COVID-19 pandemic).

23. See *infra* notes 77–92 and accompanying text (describing the importance of these required securities regulatory filings).



success is generating revenues and profits during the pandemic.<sup>24</sup>

Yet as a result of the SEC's temporary rules, these disclosures, which in some cases suggest the occurrence of fraud or misrepresentations, may have been delayed by over a month. This delay, in turn, may have exacerbated the length of time during which the market relied on incorrect information. In addition, although these particular rules applied only to reports otherwise due during the four-month period from March 1, 2020, to July 1, 2020, those months constituted a significant period for companies' disclosures concerning their financial viability at the onset of the pandemic.

In addition, the public company context presents only one area of possible concern; another is the public fund context. Public funds are entities registered as such with the SEC,<sup>25</sup> including mutual funds and exchange-traded funds (ETFs), the mainstay of retail and, importantly, retirement plan investing.<sup>26</sup> These entities are heavily regulated under the securities laws to ensure that the firms that operate them (to which this Article refers as fund managers, for ease of reference) act as fiduciaries to investors, putting investors' interests first at all times.<sup>27</sup> Accordingly, the accompanying principle under the securities

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24. See Jay Clayton & William Hinman, *The Importance of Disclosure—For Investors, Markets and Our Fight Against COVID-19*, SEC (Apr. 8, 2020), <https://perma.cc/2B7A-4LLX> (noting “Intense Investor Interest in Company-Specific Operational and Financial Status and Plans for Addressing the Effects of COVID-19” and that investors use the information in quarterly reporting, “including management commentary regarding trends, and future expectations of financial condition and risks, to gauge value and estimate future firm performance”).

25. Investment companies are therefore also public companies. However, the securities laws' regulation of them is sufficiently different from the securities laws' regulation of public companies that are business enterprises that they are a different category for purposes of this Article's discussion.

26. See, e.g., *Mutual Funds and Exchange-Traded Funds (ETFs)—A Guide for Investors*, SEC, <https://perma.cc/SX4R-ZHA5> (last updated Jan. 26, 2017) (“American investors often turn to mutual funds and exchange-traded funds (ETFs) to save for retirement and other financial goals.”).

27. See Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341, 1356 (2017) (“Because of the trust investors bestow in them, mutual fund managers are fiduciaries of the funds they manage and, by extension, their shareholders.”).

laws is to mitigate or eliminate, to the extent possible, all conflicts of interest—that is, the temptation of fund managers to put their interests ahead of investors’ interests.<sup>28</sup> Indeed, this imperative is the basis of numerous rules and obligations to which funds and fund managers are subject.<sup>29</sup>

Unlike in the public company context, however, there has been no surge of litigation or SEC disciplinary actions against funds and fund managers since the onset of the pandemic. This is not surprising, given that misconduct by fund managers, when it exists, is often detected during SEC examinations and investigations, which are typically lengthy processes even without the resource and logistics limitations wrought by the pandemic.<sup>30</sup> Nevertheless, the financial and viability challenges that public funds faced as a result of the pandemic were severe, encompassing both investor withdrawals and subpar performance. Accordingly, fund managers might have been tempted to act on conflicts of interest, such as by departing from their stated investment policies in light of market volatility or by withholding the disclosure of adverse material information about changes to fund operations. But as these and other risks

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28. See Stacy Goto Grant, Note, *International Financial Regulation Through the G20: The Proprietary Trading Case Study*, 45 GEO. J. INT’L L. 1217, 1221–22 (2014) (observing that proprietary trading by financial professionals creates conflicts of interest and that, although these conflicts “are supposed to be restricted by fiduciary relationships, . . . the desire to make money for the firm’s own account creates perverse incentives to violate any fiduciary duties”).

29. See Schwartz, *supra* note 27, at 1356–61.

30. See, e.g., Lori Richards, *Remarks Before the Greater Cincinnati Mutual Fund Association Directors’ Workshop*, SEC (Sept. 22, 2005), <https://perma.cc/GP37-P7BJ> (“The primary goal of the SEC’s examination oversight is to detect, and to deter, fraud and other violations that can harm investors.”). Indeed, the SEC’s public failures to detect fraud through its examinations have led the agency to reevaluate its examination procedures and seek to improve them. See Robert Khuzami & John Walsh, *Testimony Concerning the SEC’s Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance*, SEC (Sept. 10, 2009), <https://perma.cc/9A2D-5V46> (stating that “we failed in our fundamental mission to protect investors, and we must continue vigorously to reform the way we operate” in testimony before Congress about the agency’s “failure to detect the massive fraud perpetrated by Bernard Madoff”).

grew, the SEC adopted temporary rules to help fund managers endure crisis conditions.<sup>31</sup>

To the extent the SEC's temporary rules succeeded in assisting public companies and public funds in overcoming at least some of the financial and operational challenges arising from the pandemic, they surely were a welcome salve. With these rules in place, market participants experiencing significant operational disruptions that impeded their ability to comply with disclosure deadlines, for example, were assured that they would not be deemed to have violated the securities laws.<sup>32</sup> This result arguably benefitted not only the entities at issue but also the securities markets to the extent that it eased regulatory burdens that could interfere with market participation. At the same time, however, some of the temporary rules seemed to stand at cross-purposes with securities law objectives—namely, protecting investors and promoting capital formation—especially because those objectives become particularly critical during a crisis, when public companies and funds are facing severe challenges.

This Article evaluates temporary rules in securities regulation and previously-unexplored issues relating to them. In the process, it discusses the tensions arising from the securities regulatory imperative to protect investors and promote investor confidence in the integrity of the securities markets, on the one hand, and to incentivize and encourage the expansion and growth in a capitalist economy, on the other. Although these tensions are readily apparent, in the temporary rule context critical instances of them are largely overlooked by scholars and commentators in both the public company and the public fund realms.

Further, and more important, this Article opens new territory for analysis by evaluating which types of temporary rules are appropriate and when. That is, which types of crises

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31. See *Division of Investment Management Coronavirus (COVID-19) Response FAQs*, SEC, <https://perma.cc/TSM8-W4ZV> (last updated Nov. 1, 2021) (exploring various aspects of the SEC's implementation of temporary rules resulting from the COVID-19 pandemic and how fund managers might benefit from them).

32. See *infra* Part I.B (describing the temporary rules that the SEC adopted to ease the compliance burdens of public companies and their managers).

call for temporary rules that provide leniency, and which ones create conditions for the SEC's imposition of additional strictures on what firms can and cannot do? As this Article argues, there are important differences among types of crises—and types of industries—that should inform the SEC and other regulators navigating future crises as they make decisions about temporary rules, whether those rules provide leniency or impose more stringent regulation to prevent destructive market behavior.

As part of its project to elucidate temporary rulemaking in the securities context, this Article addresses a final component of temporary rulemaking, one that constitutes yet another arena for further exploration. Temporary rules may provide opportunities for regulatory experimentation. That is, while some temporary rules may present investor protection concerns, others may create possibilities for permanent rulemaking. In the context of the pandemic, for example, the SEC adopted temporary rules suspending requirements under both the Investment Company Act and the SEC's associated rules that certain decisions by public fund boards of directors be made during in-person board meetings.<sup>33</sup> After months during which boards relied on these rules, carrying out all meetings on online platforms, the prospect arose that the SEC might make this relief permanent—a rule change that likely would not otherwise have been under consideration and that arguably is warranted in the technology era. This is an example of how the SEC might strategically deploy temporary rules moving forward, including in non-crisis situations.

This Article consists of four parts. Part I discusses certain shareholder lawsuits against public companies and their managers that arose during the pandemic and that alleged wrongdoing based on company statements and disclosures related to conditions created by the pandemic. It further notes the types of industries that experienced significant shareholder litigation and describes the temporary regulatory relief that the SEC simultaneously provided to these entities to help them navigate pandemic-related challenges, regardless of the industry. Part II turns to public funds and fund managers,

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33. See *infra* Part III.A (describing the basis for and general content of these rules).

articulating the risks that crisis conditions create for investors in mutual funds, ETFs, and other public investment entities. In addition, it describes how, through temporary rulemaking, the SEC eased the regulatory obligations with which these entities must otherwise comply. Part III evaluates the persistence of the regulation-leniency trade-off more broadly, contending that the ways in which crisis circumstances may call for special regulatory approaches should vary based on the nature of the crisis. Through that lens, it assesses the SEC's overall approach to temporary rules during the pandemic, apart from the merits of any particular temporary rule. Finally, Part IV suggests that, although some of the temporary rules adopted during the pandemic are worrisome from an investor-protection standpoint, a swath of the temporary rules nevertheless has been more benign or even efficiency-enhancing. In addition, it contends that, to further the cause of more effective regulation, some of these rules are good candidates to become permanent rules. A brief conclusion follows.

#### I. PUBLIC COMPANIES

As soon as the pandemic took its hold on the United States and the world, it was evident that substantial litigation—specifically, shareholder class actions—would ensue as a result of the challenging circumstances the pandemic would create across the economy. By late May 2020, several hundred lawsuits stemming from the pandemic, both securities-related and otherwise, were pending in both state and federal courts, with 442 class actions filed in the United States from March 1 through the end of May 2020 alone.<sup>34</sup> In the securities context, shareholders filed substantial numbers of “pandemic lawsuits” each week, a circumstance that continued even after pandemic conditions began to subside.<sup>35</sup>

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34. See DLA PIPER, PREPARING FOR GLOBAL CLASS ACTIONS ARISING FROM COVID-19, at 2 (2020), <https://perma.cc/GC86-NPDW> (PDF) (setting forth overviews of, and statistics relating to, COVID-19-related class actions in both the United States and Canada).

35. See ELIZABETH L. MITCHELL ET AL., WILMERHALE, COVID-19: THE VIRUS CREATES NEW REGULATORY PRIORITIES AND LITIGATION RISKS FOR PUBLIC COMPANIES AND MARKET PARTICIPANTS 4 (2020), <https://perma.cc/USS5-SALK> (observing that “the pace of new private securities lawsuits has not abated.”)

Part I.A describes types of pandemic-related securities class action lawsuits that shareholders of public companies filed during the first year of the pandemic. Although the facts of each case are not themselves instructive as to the advisability of temporary rules, these lawsuits are informative as to the circumstances under which temporary rules may be appropriate. Part I.B describes an important temporary rule that the SEC adopted to alleviate certain compliance pressures that companies might experience because of pandemic conditions and associated challenges, as well as problems arising from the delayed disclosure that this rule permitted.

### A. *Pandemic Litigation*

From the beginning, a few industries were obvious candidates for federal securities litigation because the goods or services they provide have in some way played a role during the pandemic or created risks relating to it. As an example, several lawsuits filed during the first year of the pandemic were against travel companies, including cruise operators. In addition to the lawsuit against Carnival Corporation described in the Introduction, shareholders of Norwegian Cruise Lines sued the company and its CEO in mid-March.<sup>36</sup> In the latter case, plaintiffs alleged that the Form 8-K report and press release the company made public on February 20, 2020, failed to disclose the actual impact that COVID-19 was having on its customers and the company's financial outlook.<sup>37</sup> Plaintiffs further alleged that the company's Form 10-K, filed a week later, did not disclose that Norwegian sales representatives were providing false information to customers and potential customers to discourage them from cancelling cruise trips or to encourage

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that this fact is not surprising because this type of litigation “thrives on market volatility and uncertainty,” and that “[s]tock price drops create aggrieved investors”).

36. See Complaint at 1, *Douglas v. Norwegian Cruise Lines*, No. 1:20-cv-21107 (S.D. Fla. Mar. 12, 2020).

37. See *id.* at 5–7 (alleging that statements in these documents “misrepresented and failed to disclose adverse facts pertaining to the Company’s business, operations and prospects, which were known to Defendants or recklessly disregarded by them”).

them to purchase new cruise packages.<sup>38</sup> After the *Miami New Times*' March 11, 2020, publication of an article detailing Norwegian's actual circumstances, the price of the company's shares fell by 26.7 percent.<sup>39</sup> It fell by another 35.8 percent on March 12, 2020, after the *Washington Post* published an article disclosing additional information about Norwegian's sales tactics.<sup>40</sup>

Other types of travel companies, such as airlines, also became pandemic class-action defendants, in light of the pandemic's substantial adverse effect on air travel. Shareholders of GOL Linhas Aereas Inteligentes, a Brazilian airline, sued the company and its CEO on September 30, 2020, alleging that, through July, the company had made false and misleading statements about the quality of its internal controls and strength of its financial outlook.<sup>41</sup> The company's stock price fell by an aggregate 12.6 percent allegedly based on, among other things, the company's June 16, 2020, disclosure of weaknesses in its internal controls,<sup>42</sup> its disclosure in its annual report filed on June 29, 2020, that its independent auditor had expressed doubts about its continuation,<sup>43</sup> and its July 23, 2020, announcement that it had terminated its independent auditor.<sup>44</sup>

Pharmaceutical and health care companies were a second unsurprising litigation target. On the same day that shareholders filed the Norwegian Cruise Lines action, a second

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38. *See id.* at 7 (noting that the company had employed "sales tactics of providing customers with unproven and/or blatantly false statements about COVID-19 to entice [them] to purchase cruises").

39. *See id.* at 7–8 (quoting relevant excerpts from the *Miami New Times*' article).

40. *See id.* at 9 (quoting relevant excerpts from the *Washington Post* article).

41. *See* Complaint at 4–10, *Timotheo v. GOL Linhas Aereas Inteligentes S.A.*, No. 1:20-cv-04644 (E.D.N.Y. Sept. 30, 2020) (setting forth alleged misstatements spanning a period from February 20, 2020, through July 31, 2020).

42. *See id.* at 7–8 (quoting relevant excerpts from the company's June 16 disclosure, which was in the form of a Form 12b-25 SEC filing).

43. *See id.* at 9 (quoting relevant excerpts from the company's June 29 disclosure).

44. *See id.* at 9–10 (quoting relevant excerpts from the company's July 23 announcement).

set of shareholders sued Inovio Pharmaceuticals and its CEO on the basis that the company falsely claimed in mid-February 2020 that it had developed a COVID-19 vaccine in a matter of hours and that human testing of the product was imminent.<sup>45</sup> Having quadrupled during this time,<sup>46</sup> the company's stock price dropped by 71 percent after a short-seller called out the alleged misstatements—disclosing that, in fact, the company had not developed a vaccine for COVID-19—and publicly urged the SEC to investigate.<sup>47</sup>

In another health care case, shareholders of SCWorx Corp., a health care technology company, sued the company and its CEO on April 29, 2020, alleging that the company's mid-April press release, in which it announced that it had received a large order for COVID-19 testing kits with ongoing significant weekly orders thereafter, was misleading and false.<sup>48</sup> The plaintiffs further alleged that the company's stock price sank by over 17 percent when, less than a week after the press release, a research firm issued a report stating that the orders were “completely bogus,” that the company's CEO had been previously convicted of tax evasion, and that the CEO of the company's supplier had “questionable credibility,” among other things.<sup>49</sup> Five days later, the SEC stopped trading of the company's stock.<sup>50</sup>

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45. See Complaint at 3, *McDermid v. Inovio Pharms., Inc.*, No. 2:20-cv-01402-GJP (E.D. Pa. Mar. 12, 2020) (quoting J. Joseph Kim, the company's CEO, who stated that the company had developed a COVID-19 vaccine “in a matter of about three hours once we had the DNA sequence from the virus”).

46. According to the complaint, the stock price rose “from \$4.28 per share on February 28, 2020” to “an intra-day high of \$19.36 on March 9, 2020.” *Id.* at 4.

47. See *id.* at 4 (noting that the stock price dropped from an opening price of \$18.72 on March 9, 2020, to a closing price of \$5.70 on March 10, 2020).

48. See Complaint at 1, *Yannes v. SCWorx Corp.*, No. 1:20-cv-03349 (S.D.N.Y. Apr. 29, 2020) (recounting that the company announced that it had received orders for “two million COVID-19 rapid testing kits, ‘with provision for additional weekly orders of 2 million units for 23 weeks, valued at \$35M per week’”(citation omitted)).

49. See *id.* at 5–6 (quoting and highlighting relevant excerpts from the research report).

50. See *id.* at 6 (detailing that the SEC halted trading of SCWorx Corp.'s stock on April 22, 2020).



In three other cases against pharmaceutical companies, shareholders alleged false and misleading statements relating to the efficacy of COVID-19 testing products under development.<sup>51</sup> The plaintiffs' claims in these cases were that the relevant company made false and misleading statements in saying either that it had discovered an antibody that "demonstrated 100% inhibition" of COVID-19 infection or that its diagnostic test for COVID-19 or antibodies, as the case may be, was 100 percent accurate.<sup>52</sup> The revelation of the truth in each case—namely, that the companies' respective products were not 100 percent effective or accurate—occurred from mid-May through mid-June 2020, including through a Form 8-K filing. Allegedly as a result of these disclosures, the three companies' stock prices declined by 49 percent, 38 percent, and 60 percent, respectively.<sup>53</sup>

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51. See Complaint at 7, *Wasa Med. Holdings v. Sorrento Therapeutics, Inc.*, No. 3:20-cv-00966-AJB-AGS (S.D. Cal. May 26, 2020) [hereinafter *Sorrento Therapeutics Complaint*] (quoting Mark R. Brunswick, a Vice President of the company, who stated on May 15, 2020 that, "[a]s soon as [the antibody] is infused, that patient is now immune to the disease . . . [f]or the length of time, the antibody is in that system"); Complaint at 12–13, *Gelt Trading, Ltd. v. Co-Diagnostics, Inc.*, No. 2:20-cv-00368-CMR (D. Utah June 15, 2020) [hereinafter *Co-Diagnostics Complaint*] (quoting a May 1, 2020, press release from the company stating that the performance data for its COVID-19 diagnostics test "demonstrate[ed] 100% sensitivity and 100% specificity, the metrics used to determine accuracy in molecular diagnostics testing"); Complaint at 9, *Chernysh v. Chembio Diagnostics, Inc.*, No. 2:20-cv-02706-ARR-ARL (E.D.N.Y. June 18, 2020) [hereinafter *Chembio Diagnostics Complaint*] (quoting a May 4, 2020, statement by Richard L. Eberly, the company's CEO, that the "accuracy of the [test] after 11 days post the onset of symptoms is 100% for total antibodies").

52. See *Sorrento Therapeutics Complaint*, *supra* note 51, at 7; *Co-Diagnostics Complaint*, *supra* note 51, at 12–13; *Chembio Diagnostics Complaint*, *supra* note 51, at 9.

53. See *Sorrento Therapeutics Complaint*, *supra* note 51, at 10 (noting that, after the third parties placed the company's claims into doubt beginning on May 20, 2020, the company's stock price declined by over 49 percent); *Co-Diagnostics Complaint*, *supra* note 51, at 15 (noting that disclosures by third parties on May 14, 2020, cast the company's claims into doubt and that the company's stock price fell by more than 38 percent as a result); *Chembio Diagnostics Complaint*, *supra* note 51, at 12 (claiming that the company's stock price declined by over 60 percent as a result of the FDA's June 16, 2020, disclosure contradicting the company's claims).

A third category of early-pandemic litigation involved the mainstay of working-from-home videoconferencing services—namely, Zoom. Alleging that Zoom Video Communications and its CEO failed to use appropriate data privacy and security protocols, shareholders of the company sued on April 7, 2020.<sup>54</sup> Although, according to the plaintiffs, the truth began to emerge in July 2019 following third party disclosures that a user’s Zoom camera function could be remotely enabled by external malicious websites,<sup>55</sup> details about Zoom’s allegedly inadequate security measures and information-sharing practices became fully apparent only after the pandemic had begun.<sup>56</sup> When news articles published in late March 2020 revealed this, the company’s stock price dropped by 19.62 percent and dropped another 4.1 percent on April 6, 2020, after the publication of additional news articles.<sup>57</sup>

Despite these more “obvious” types of lawsuit targets, many securities class action lawsuits arising early-on in the pandemic instead involved the basic concerns that defendant companies, including those without any special relationship to or involvement with the pandemic, misrepresented the pandemic’s effect on their financial results and projections and overall operations. Two of the examples that opened this Article fall into this category.<sup>58</sup> Another example was the lawsuit brought by shareholders of Ideanomics, Inc., a company with operations in China.<sup>59</sup> In their June 28, 2020, complaint, the plaintiffs claimed that between March and June 2020—when pandemic-related shutdowns were adversely affecting businesses in China—the company issued false and misleading press releases that claimed strong performance by its electric car division, among

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54. See Complaint at 7–13, *Drieu v. Zoom Video Commc’ns, Inc.*, No. 5:20-cv-02353-JD (N.D. Cal. Apr. 7, 2020) (stating that the company “failed to disclose material adverse facts about [its] business, operational and compliance policies” and setting forth specific bases for these claims).

55. See *id.* at 8–9.

56. See *id.* at 14–19 (noting a series of media reports regarding Zoom’s security practices and associated scrutiny from two state Attorneys General).

57. See *id.* at 17–18.

58. See *supra* notes 4–10 and accompanying text.

59. See *generally* Complaint, *Lundy v. Ideanomics, Inc.*, No. 1:20-cv-04944 (S.D.N.Y. June 29, 2020).

other things.<sup>60</sup> Shortly thereafter, the company announced plans to offer \$250 million in common stock, after which a research analyst contended in a series of tweets that Ideanomics had made a variety of false statements in its then-recent press releases and that the releases were a part of the company's "stock pump and dump on a neverending [sic] stream of press releases over the past 5 years."<sup>61</sup> Allegedly as a result of these tweets and additional ones from another third-party researcher, the company's stock price fell almost 53 percent over two days.<sup>62</sup>

These securities class-action lawsuits are merely representative of all those that shareholders in a range of industries have filed since the pandemic started. To be sure, not all of the lawsuits have been (or will be) found to have merit.<sup>63</sup> However, these suits represent the tip of an iceberg of pandemic-related securities litigation.<sup>64</sup> This type of litigation is, after all, fueled by price volatility and market uncertainty—the products of a rapidly-evolving business environment.<sup>65</sup> That is, when a company's stock price falls, shareholders become aggrieved.<sup>66</sup> Meanwhile, even for the most forthright companies, when the surrounding economic and business environments evolve rapidly, even recent disclosures quickly become obsolete.<sup>67</sup> Nevertheless, just as the factors

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60. *See id.* at 6–9 (quoting relevant excerpts from Ideanomics's press releases in March through June 2020).

61. *Id.*

62. *Id.* at 14.

63. Meritless securities class actions have been a concern among courts and Congress for years, and Congress's attempt to curb meritless claims in favor of meritorious ones, the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.), has not produced the intended results. *See Congress, the Supreme Court, and the Rise of Securities-Fraud Class Actions*, 132 HARV. L. REV. 1067, 1071 (2019) (“[W]hile the PSLRA did reduce frivolous lawsuits to some extent, the continuing surge in securities-fraud class actions suggests that excessive litigation remains a serious problem.”).

64. *See ELIZABETH L. MITCHELL ET AL., supra* note 35, at 4 (“Although each day seems to bring news of yet another court curtailing operations and limiting new filings, the pace of new private securities lawsuits has not abated, and we anticipate that it is likely to increase.”).

65. *See id.*

66. *See id.*

67. *See id.*

causing the surge of shareholder litigation are important, the lessons we might learn from that surge, in terms of developing more effective temporary regulation, are as well.

### B. *Temporary Rules for Public Companies*

In large part, temporary rules are intended to provide leniency to companies in complying with the many obligations to which they are subject under the securities laws.<sup>68</sup> Not only is securities law compliance onerous and time-consuming for publicly-held companies, it is also expensive.<sup>69</sup> Not surprisingly, all three aspects—the burden, the time allotment, and the expense—heighten the operational and financial challenges that companies face during crisis situations.<sup>70</sup> This section discusses the significance of what is, arguably, the most significant temporary rule that the SEC adopted to assist public companies in navigating the challenges caused by the pandemic and the adjustments to company operations that the pandemic necessitated. Although this rule was relatively short-lived—the SEC did not extend it after July 1, 2020,<sup>71</sup> likely because of the

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68. See, e.g., Press Release, SEC, SEC Provides Temporary, Conditional Relief to Allow Small Businesses to Pursue Expedited Crowdfunding Offerings (May 4, 2020), <https://perma.cc/A8YT-A338> (“The temporary rules are the latest in a series of steps the Commission has taken to assist financial market participants in addressing the impacts of the coronavirus.”).

69. See 3A HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SEC. & FED. CORP. L. § 8:1 (2d ed. 2020) (assessing the “possible disadvantages” of becoming a public company as “certain reporting, proxy solicitation, insider trading and other responsibilities under the Securities Act of 1933 and the Securities Exchange Act of 1934, all of which are time-consuming and expensive”).

70. See GIBSON DUNN, SEC ENFORCEMENT FOCUS ON FALLOUT FROM COVID-19: INSIGHTS FOR PUBLIC COMPANIES AND INVESTMENT ADVISERS DURING A CRISIS 1 (2020), <https://perma.cc/NT3V-8YS4> (PDF) (“History teaches us that unprecedented market volatility, fast moving economic events, and dislocations create substantial challenges for compliance . . .”).

71. See Press Release, SEC, SEC Extends Conditional Exemptions from Reporting and Proxy Delivery Requirements for Public Companies, Funds, and Investment Advisers Affected by Coronavirus Disease 2019 (COVID-19) (Mar. 25, 2020), <https://perma.cc/2C7X-V8A7> (providing a forty-five-day extension to file certain disclosure reports that would otherwise have been due between March 1 and July 1, 2020).

stock market's partial recovery by that point—it could have endured much longer, as many past temporary rules have.<sup>72</sup>

On March 4, 2020, the SEC's Division of Corporation Finance adopted a temporary rule that, while in effect, extended the deadline for the filing of certain required disclosure reports with the SEC.<sup>73</sup> Under the rule, companies that were unable to meet a filing deadline for reports due between March 1 and May 1, 2020, because of COVID-19-related circumstances were granted an additional forty-five days to submit the reports, including annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K.<sup>74</sup> Pursuant to an extension of this rule on March 30, 2020,<sup>75</sup> the relief applied to reports that would otherwise have been due between March 1 and July 1, 2020.<sup>76</sup>

This temporary rule was one of the most important of the SEC's temporary rules during the pandemic—at least as among those that applied to public companies, as opposed to public funds—because reports filed on Forms 10-Q, 10-K, and 8-K are important. All three reports are required by SEC rules, which the agency adopted per its authority under the Securities

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72. See, e.g., Extension of Temporary Registration of Municipal Advisors, Exchange Act Release No. 70,468, 78 Fed. Reg. 59,814, 59,814 (extending the effective period of a temporary rule from September 2013 to December 2014).

73. See 2020 Disclosure Rule, *supra* note 11, at 13,680–81 (providing the conditions under which the deadlines were extended).

74. See *id.* at 13,681 (listing, as a condition of a company's reliance on the rule, that the company "files with the Commission any report, schedule, or form required to be filed no later than 45 days after the original due date"). Under a separate temporary rule adopted on March 26, 2020, the Division gave affected companies the same forty-five-day extension to file disclosure reports under Regulation A and Regulation Crowdfunding—rules that allow companies to sell certain dollar amounts in securities without registering the offerings with the SEC—that were otherwise required to be filed between March 26 and May 31, 2020. See Relief for Form ID Filers and Regulation Crowdfunding and Regulation A Issuers Related to Coronavirus Disease 2019 (COVID-19), Exchange Act Release No. 10,768, 85 Fed. Reg. 17,747, 17,748 (Mar. 31, 2020) (to be codified at 17 C.F.R. pts. 227, 230, and 232).

75. See 2020 Disclosure Rule Extension, *supra* note 14, at 17,610, 17,610 (Mar. 30, 2020) (extending the rule to July 1, 2020).

76. See *id.* (extending the rule on the basis that "market participants continue to face challenges in meeting the reporting and proxy delivery requirements of the federal securities laws in a timely manner").

Exchange Act of 1934.<sup>77</sup> All three reports, moreover, are critical sources of information for investors and prospective investors.<sup>78</sup> In light of the importance of these reports, a brief description of each is warranted.

The Form 10-K report is a comprehensive report that public companies must file with the SEC on an annual basis.<sup>79</sup> It is even more comprehensive than a company's annual report, which the company prepares and sends to shareholders prior to the annual shareholder meeting to detail its activities throughout the preceding year.<sup>80</sup> Among the items that companies must include in their Form 10-K reports are information and disclosures about their business operations, financial health (which must include audited financial statements), subsidiaries and affiliates, executive compensation, dividend policies, material legal proceedings, risk factors, and properties owned.<sup>81</sup>

Because of its detail and depth of information, a Form 10-K report is regarded as the most important document issued by a

77. See James A. Fanto et al., *Justifying Board Diversity*, 89 N.C. L. REV. 901, 907 n.17 (2011)

A public company has multiple disclosure obligations, including the filing of an annual report on Form 10-K, 17 C.F.R. § 240.15d-1 (2010); the filing of quarterly reports on Form 10-Q, § 240.15d-13; the filing of “special” reports on Form 8-K whenever one of the events enumerated in the Form occurs, § 240.15d-11; and the filing of a proxy statement for the annual shareholders’ meeting (as well as for special meetings), 17 C.F.R. § 240.14a-3 (2010).

78. See *Knowing the Difference Between a 10-K, 10-Q and an 8-K*, DAVEMANUEL.COM (July 31, 2008), <https://perma.cc/6U4Y-ZXZ7> (characterizing these reports as important because they “force” companies “to completely disclose pertinent information about their business and corporate structure to investors”).

79. See 17 C.F.R. § 240.15d-1 (2021) (“Every registrant under the Securities Act of 1933 shall file an annual report, on the appropriate form authorized or prescribed therefor, for the fiscal year in which the registration statement under the Securities Act of 1933 became effective and for each fiscal year thereafter . . .”).

80. See Will Kenton, *10-K*, INVESTOPEDIA, <https://perma.cc/NAJ4-B268> (last updated Mar. 16, 2020) (comparing the Form 10-K report to the annual shareholder report).

81. See *id.* (describing the information to be reported on Form 10-K).

public company.<sup>82</sup> However, Form 10-Q is important in its own right because companies must file it more frequently—namely, on a quarterly basis.<sup>83</sup> Although it is similar to Form 10-K, it requires fewer details,<sup>84</sup> and although it requires the submission of financial statements, those statements may be unaudited.<sup>85</sup> One purpose of Form 10-Q is to present a comparison of a company's performance in the current financial quarter with its performance in the previous one.<sup>86</sup>

The reports on Forms 10-K and 10-Q are important for another reason. Each requires a narrative, found in the Management Discussion and Analysis (MD&A) section, that explains a company's financial results and elaborates on (and provides context for) its overall financial condition and any variations in its cash flow and earnings.<sup>87</sup> Because the MD&A section sets forth the views and opinions of a company's managers—the only part of the form that does so—it helps

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82. See *id.* (noting that “[b]ecause of the depth and nature of the information they contain, 10-Ks are fairly long and tend to be complicated” but that “investors need to understand that this is one of the most comprehensive and most important documents a public company can publish on a yearly basis”).

83. See 17 C.F.R. § 240.15d-13(a) (2021) (“[E]very issuer that has securities registered pursuant to the Securities Act and is required to file annual reports pursuant to section 15(d) of the Act on Form 10-K . . . shall file a quarterly report on Form 10-Q . . .”).

84. See GERD D. THOMSEN, MORRISON & FOERSTER, FREQUENTLY ASKED QUESTIONS ABOUT PERIODIC REPORTING REQUIREMENTS FOR U.S. ISSUERS PRINCIPAL EXCHANGE ACT REPORTS 6 (2013), <https://perma.cc/7W8B-6NPS> (PDF) (“Form 10-Q contains information similar to that contained in the Form 10-K, however, the information is generally less detailed.”).

85. See *Form 10-Q*, INVESTOR.GOV, <https://perma.cc/8MMD-XASG> (“The Form 10-Q includes unaudited financial statements and provides a continuing view of the company's financial position during the year.”).

86. See Will Kenton, *SEC Form 10-Q Definition*, INVESTOPEDIA, <https://perma.cc/7HS9-24WQ> (last updated Apr. 16, 2021) (“Investors can use [Form 10-Q] to get a sense of [a company's] quarterly earnings and other elements of its operations, and to compare them to previous quarters—thus tracking its performance.”).

87. See *How to Read a 10-K/10-Q*, INVESTOR.GOV (Jan. 25, 2021), <https://perma.cc/NP3M-567F> (noting that the MD&A section presents, among other things, “[t]he company's operations and financial results, including information about the company's liquidity and capital resources and any known trends or uncertainties that could materially affect the company's results”).

provide an indication of how the company may perform going forward.<sup>88</sup> However, although the section contains managers' opinions, those opinions must have a factual basis and reflect a balanced vision of the company's prospects.<sup>89</sup>

Form 8-K reports are a third public disclosure report of note, the objective behind them being to allow companies to provide *current* disclosure about noteworthy events.<sup>90</sup> That is, a company is required to use Form 8-K to disclose certain unscheduled material events relating to the company's operations that may be of importance to investors, the SEC, or the securities markets more generally.<sup>91</sup> Events necessitating that a company file a Form 8-K report include, among other things, the resignation or appointment of a director, changes to the company's financial situation, bankruptcy, closing an acquisition, delisting a class of the company's shares, termination of its auditor, revisions to its code of ethics, and other events that the company considers important for investors.<sup>92</sup>

Collectively, Forms 10-K, 10-Q, and 8-K are intended to keep investors and the securities market informed about public companies' operations and financial health. Indeed, that is the

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88. *See id.* (noting that the MD&A section "allows company management to tell its story in its own words").

89. *See* Marshall Hargrave, *Management Discussion and Analysis—MD&A*, INVESTOPEDIA, <https://perma.cc/MP6D-ZWLE> (last updated Sept. 30, 2020) (noting that the Financial Accounting Standards Board requires that statements in the MD&A "be based on fact" and that "there . . . be an attempt to paint a balanced picture of the company's future prospects").

90. *See* 17 C.F.R. § 240.15d-11 (2021) ("[E]very registrant [required to file Forms 10-K] shall file a current report on Form 8-K within the period specified in that form unless substantially the same information as that required by Form 8-K has been previously reported by the registrant.").

91. *See* OFF. OF INV. EDUC. & ADVOC., SEC, INVESTOR BULLETIN: HOW TO READ AN 8-K 1 (2021), <https://perma.cc/BN6V-YCQD> (PDF) (observing that "[t]he types of information required to be disclosed on Form 8-K are generally considered to be 'material,'" meaning that "there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision").

92. *See Form 8-K*, SEC, <https://perma.cc/E8LJ-2RHX> (last updated Aug. 10, 2012) (listing the events that trigger a company's obligation to file a Form 8-K).



purpose of all of the required public disclosures by companies under the SEC's authority.<sup>93</sup> Armed with the disclosures on these forms, investors are better able to make informed decisions about whether to invest in or divest from a company, and informed observers are better able to analyze the company and make recommendations to investors about whether to invest in it.<sup>94</sup> Further, so informed about the repositories of their investments, investors, ideally, should be able to gain confidence in the market, thereby increasing the likelihood they will invest beyond what would be the case if they were uninformed.<sup>95</sup>

Considering the litigation briefly detailed in Part I.A, the problem with delaying the disclosure of company information under certain circumstances is clear. Doing so may delay the disclosure of accurate information to the market. This is critical in normal circumstances, but it is especially critical when the market has previously been misled about a company's operations or financial performance and is relying on those earlier misstatements. Without timely disclosure, this reliance may continue, likely increasing the losses incurred when the truth is disclosed. To be sure, Forms 10-K, 10-Q, and 8-K may serve as vehicles for new misstatements and inaccuracies. But unlike a company's distribution of fraudulent information

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93. See Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599, 605 (2013) (noting that “[t]he 1933 and 1934 Acts have always been very much focused on disclosure” and that the statutes’ legislative history ties “disclosure and finance inextricably to the integrity of the markets”).

94. See Susanna Kim Ripken, *Paternalism and Securities Regulation*, 21 STAN. J.L. BUS. & FIN. 1, 2 (2016) (observing that disclosure requirements, unlike merit-based securities regulation, “merely require the dissemination of relevant information, thereby empowering investors to analyze their options and make optimal investment decisions based on disclosed potential risks and returns”). However, some observers question whether disclosure—whether through Forms 10-K, 10-Q, and 8-K or otherwise—actually furthers this objective. See Davidoff & Hill, *supra* note 93, at 603 (“[T]he role of disclosure in investment decisions is far more limited, and far less straightforward, than is typically assumed.”).

95. See Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 999 (2006) (“The logic of federal securities regulation . . . is that the mandatory disclosure regime . . . shores up investor confidence and the integrity of securities markets by redressing information asymmetries and targeting fraud.”).

through press releases or other disclosures, using Forms 10-K and 10-Q, in particular, is perilous for the company's principal executives, given that they are subject to criminal prosecution if the reports are found to be inaccurate or incomplete.<sup>96</sup>

## II. PUBLIC FUNDS

Similar to public companies, mutual funds, ETFs, and other public investment entities experienced significant challenges as a result of the pandemic. More precisely, the fund managers that operate them were challenged as a result of sharp stock-market declines and volatility that led many fund investors to withdraw their capital and fund performance to drop appreciably.<sup>97</sup> Both factors served to diminish public fund assets and, in turn, the amount of management fees that funds pay to the fund managers that oversee them.<sup>98</sup> Although the market generally

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96. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 906, 116 Stat. 745 (2002) (providing requirements for corporate responsibility for financial reports). The Act requires that “[e]ach periodic report containing financial statements filed by [a company] with the [SEC] pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934” be accompanied by a certification by the company’s CEO and CFO that the information in the report “fairly [presents] . . . the financial condition and results of operations of the [company].” *Id.* The Act also provides criminal penalties for a certifier who intentionally certifies a report failing to meet this requirement. *Id.*

97. See EVA SU, CONG. RSCH. SERV., R46424, CAPITAL MARKETS VOLATILITY AND COVID-19: BACKGROUND AND POLICY RESPONSES i (2020) (noting that “[t]he fund market has . . . experienced high volatility due to COVID-19” and that “[s]ome funds received new sources of liquidity through the SEC’s temporary allowance of certain interfund lending and the federal government’s emergency intervention programs”); Dave Michaels et al., *SEC Gives Relief to Mutual Funds Facing Redemption Issues*, WALL ST. J. (Mar. 24, 2020, 3:08 PM), <https://perma.cc/J8PR-VCK9> (“Investors pulled \$40 billion from taxable bond funds last week alone, and net outflows have totaled \$55 billion in the past month . . .”).

98. The management fees that fund managers earn for managing a fund’s portfolio are typically calculated as a percentage of the net value of the assets that the fund holds. See James Chen, *Management Fee*, INVESTOPEDIA (Nov. 12, 2020), <https://perma.cc/5PEM-QBQU>. As a result, to the extent that market volatility produces investment losses and the fund’s investors withdraw their capital, the product of that calculation diminishes.

recovered from the volatility early on, for many funds, investor assets were slow in returning.<sup>99</sup>

Section II.A delves into the particular risks facing fund investors during the pandemic and, in this context, the particular concerns that conflicts of interest posed. Section II.B describes the temporary rules that the SEC adopted to alleviate some of the challenges facing funds and fund managers, including how these rules may have fostered the conflicts that fund regulation has sought to mitigate. Although these temporary rules differed significantly from the rule extending disclosure filing deadlines for public companies, they are instructive in their own right, especially in terms of lessons to be learned in grappling with future crises.

#### A. *Pandemic Conflicts of Interest*

The securities laws and rules governing fund managers and the public funds (mutual funds and so forth) that they manage are substantively different from those governing public and private companies not focused on investment services. Among other things, the Investment Company Act of 1940,<sup>100</sup> which governs funds themselves, and its companion statute, the Investment Advisers Act of 1940,<sup>101</sup> which governs investment advisers (a group that includes fund managers) are relatively rule-focused.<sup>102</sup> Meanwhile, the two better-known securities statutes—the Securities Act of 1933,<sup>103</sup> which regulates public

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99. Cf. Bob Sullivan & Benjamin Curry, *Covid-19 Crisis: Investing Lessons from the Pandemic*, FORBES ADVISOR, <https://perma.cc/V89G-M8BF> (last updated Mar. 24, 2021, 9:32 AM) (“It took five months to retrace the early Covid-19 losses and start hitting new all-time highs.”); CARY STIER, DELOITTE, *COVID-19’S IMPACT ON THE INVESTMENT MANAGEMENT SECTOR* (2020), <https://perma.cc/82RJ-YXTD> (noting that “liquidity remains scarce and the outlook for earnings is soft” in terms of global economic outlook).

100. 15 U.S.C. §§ 80a-1–80a-64.

101. 15 U.S.C. §§ 80b-1–80b-21.

102. See, e.g., Porter Wright, *How to Avoid Registration Under the Investment Company Act of 1940*, FED. SEC. L. SOURCE (Mar. 13, 2018), <https://perma.cc/8F2X-U8V6> (“The act is draconian in its regulation and can change the entire business of a company.”).

103. 15 U.S.C. §§ 77a–77aa.

securities offerings, and the Securities Exchange Act of 1934,<sup>104</sup> which regulates securities transactions in the secondary market—are more general because they are centered around disclosure requirements and fraud prohibitions.<sup>105</sup>

Specifically, the latter two statutes' primary regulatory levers are the requirements to disclose all relevant material facts and to do so truthfully and completely.<sup>106</sup> Meanwhile, the “investment” statutes regulate via specific rules that apply to virtually all facets of a public fund's and its manager's operations. For example, the Investment Company Act and the rules the SEC has adopted under that statute contain limitations on a public fund's holdings of “illiquid” securities,<sup>107</sup> the amount and form of borrowing the fund may do,<sup>108</sup> and, for a fund that is deemed “diversified,” the amount of net assets that the fund may invest in an individual portfolio company and the size of its ownership interest in any individual portfolio company.<sup>109</sup> The statute and rules also prohibit, or severely

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104. 15 U.S.C. §§ 78a–78kk.

105. See, e.g., *The Laws that Govern the Securities Industry*, SEC, <https://perma.cc/5LJG-WRSK> (“Often referred to as the ‘truth in securities’ law, the Securities Act of 1933 has two basic objectives: require that investors receive financial and other significant information concerning securities being offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities.”).

106. See Heather G. White, *A Little Help from Our Friends: Moving Beyond Enforcement to Improve State and Local Government Compliance with Federal Securities Laws*, 22 N.Y.U. J. LEGIS. & PUB. POL'Y 129, 141–42 (2019) (“[T]he principal purposes of the Securities Act and the Exchange Act, and of the regulations promulgated under these acts, are promoting accurate and complete disclosure about securities sold to the public and preventing fraudulent or unfair practices in the sale of securities.”); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 869 (2003) (observing that the Securities Act and the Securities Exchange Act “focus on protecting the integrity of the markets both by demanding that specific documents exist and by requiring that, when made, all disclosures be complete and accurate”).

107. See, e.g., 17 C.F.R. §§ 239, 274 (2008) (limiting a mutual fund's illiquid positions as a percentage of fund assets).

108. See 15 U.S.C. § 80a-18(f)(1) (“It shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security of which it is the issuer . . .”).

109. See 15 U.S.C. § 80a-5(b)(1). This section provides that, to be diversified, a public fund must hold “[a]t least 75 per centum of the value of its total assets” in cash or securities, “limited in respect of any one issuer to an

limit, affiliates of a public fund from buying securities from or selling securities to the public fund,<sup>110</sup> borrowing money or property from the fund, or loaning money or property to the fund.<sup>111</sup> They additionally prohibit a public fund from issuing debt securities or borrowing money from entities other than banks.<sup>112</sup> For its part, the Investment Advisers Act and associated SEC rules, while more succinct, also contain an array of rules governing both fund managers and all other SEC-regulated investment advisers.<sup>113</sup>

The collection of mandates in the investment statutes, particularly ones limiting a public fund's transactions with affiliates, evidences their primary role in the investment arena: mitigating conflicts of interest. Conflicts of interest are especially rife among fund managers and other fund affiliates. In part, this is a product of the fact that managers and other affiliates—a term that includes brokerage firms or other investment advisers operated by the same larger (multi-entity) organization or other funds operated within that organization—may seek to benefit from a fund's position within the organization.<sup>114</sup> For example, a fund manager that executes

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amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer." *Id.*

110. See 15 U.S.C. § 80a-17(a)(1), (2) (broadly prohibiting purchases and sales of securities between an affiliate of a public fund and the fund). Despite this blanket prohibition on affiliate transactions, the SEC's rules allow for these transactions between a public fund and an affiliated public fund (so-called cross-transactions), subject to certain conditions, including that each such transaction be done at market price and that no brokerage fee is charged. See 17 C.F.R. § 270.17a-7 (2006).

111. See 15 U.S.C. § 80a-17(a)(3)-(4) (broadly prohibiting borrowing and lending transactions between an affiliate of a public fund and the fund).

112. See 15 U.S.C. § 80a-18(f)(1) ("It shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security of which it is the issuer, except that any such registered company shall be permitted to borrow from any bank . . .").

113. See *General Information on the Regulation of Investment Advisers*, SEC (Mar. 11, 2011), <https://perma.cc/9QVT-K3S4> (summarizing the myriad rules governing investment advisers under the Investment Advisers Act).

114. See Roberta S. Karmel, *The Challenge of Fiduciary Regulation: The Investment Advisers Act After Seventy-Five Years*, 10 BROOK. J. CORP. FIN. & COM. L. 405, 435 (2016) ("Conflicts of interest are common in every fiduciary relationship in the financial services industry.").

a fund's trades using an affiliated broker may, for the benefit of the broker, accept the fund's paying brokerage commissions that are higher than market rates. Or the manager may cause the fund to sell securities to another fund it manages at an inappropriate discount because the manager has a large investment in the other fund. Or the manager may cause the fund to buy a particular stock, knowing that the stock price will rise because of that purchase, thereby allowing the manager to sell its personal holdings of the same stock at a more desirable price.<sup>115</sup>

Distilling these examples, one may conclude that potential conflicts arise in the investment realm because of two circumstances. First, the investment realm contains innumerable complex webs of affiliated entities.<sup>116</sup> Second, and more important, most of these affiliates have a uniform business objective, which is to profit from investing activities, whether by investing their own assets, managing other entities' assets, brokering securities transactions for others, or playing other roles in investment transactions.<sup>117</sup> For some of these affiliates, this business objective may come precariously close to another objective—namely, inappropriately profiting from another person's (or entity's) investing.

Beyond these circumstances, conflicts of interest arise from the basic fact that fund managers strive to be successful in managing “their” funds.<sup>118</sup> In this context, being successful often means increasing fund assets, ideally by increasing the number

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115. See *id.* at 417 (listing examples of conflicts of interest among financial professionals, including an investment adviser's trading for its own account and a broker's recommending to others the purchase of a security she owns or having a personal interest in a particular transaction).

116. See Stephen Cecchetti & Kim Schoenholtz, *Managing Risk and Complexity: Legal Entity Identifier*, VOX EU (Dec. 3, 2017), <https://perma.cc/X6B5-XUDA> (describing the risk involved in several affiliated entity structures within the investment world).

117. See, e.g., Nathan Reiff, *Six Companies Owned by Bank of America*, INVESTOPEDIA (July 14, 2021), <https://perma.cc/4J85-H55Y>.

118. See Citywire Research Team, *What Do Successful Fund Managers Have in Common?*, CITYWIRE SELECTOR (Feb. 21, 2011), <https://perma.cc/BWX3-GENZ> (“We attach a great deal of importance to detecting the ability of equity fund managers to generate significant and recurring outperformance at certain phases of the stock market cycle.”).

of fund investors and the amount of their investments, and by achieving strong fund performance.<sup>119</sup> The two factors are clearly related, moreover, because performance results are perhaps the primary factor in attracting new fund investors and additional investments from existing investors.<sup>120</sup> Accordingly, a manager seeking to improve performance may invest fund assets in securities and other instruments that are riskier than what the fund's investment policy allows in hopes of realizing a quick performance boost or may seek to sell poorly-performing securities to an affiliated fund at a price that is higher than the securities' market value, thereby harming the affiliated fund.

Regulation of public funds and their managers, then, reflects regulators' assessments of how these entities are most tempted. Moreover, in formulating the Investment Company Act and rules under that statute over eighty years ago, Congress and the SEC deemed it insufficient simply to instruct these entities not to allow themselves to be tempted.<sup>121</sup> Thus emerged the extensive prohibitions throughout public fund regulation, which are an effort (in the ironic words of one SEC official in 2012) to eliminate constantly-mutating "viruses"—that is,

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119. Cf. James Chen, *Hedge Fund Manager*, INVESTOPEDIA, <https://perma.cc/75JK-K4FM> (last updated Feb. 28, 2021) (explaining that private fund managers "must consider how to have a competitive advantage, a clearly defined investment strategy, adequate capitalization, a marketing and sales plan, and a risk management strategy" to be successful); Citywire Research Team, *supra* note 118 ("Normally, consistently outperforming managers share a rigorous investment process which in itself is created to generate alpha.").

120. See Jason Zweig, *Why Investors Can't Kick the 'Past Performance' Habit*, WALL ST. J. (July 23, 2021, 10:45 AM), <https://perma.cc/Z4EM-NBFL> (discussing how investors often think that past performance is "a highly reliable indicator"). That this is the case, however, is contrary to a particular (and apt) disclosure included in almost all presentations of fund performance, namely, that past performance is not an indicator of future performance. See Peter Westaway, *Show Me the Proof: Is Past Performance a Good Guide to the Future?*, VANGUARD (June 23, 2017), <https://perma.cc/HR7N-J3X2>.

121. See James Chen, *Investment Company Act of 1940*, INVESTOPEDIA (May 19, 2021), <https://perma.cc/AR35-HEPY> (explaining that Congress intended the Investment Company Act of 1940 to set a regulatory framework for investment products following the stock market crash of 1929).

conflicts—that could otherwise pose a “mortal threat to the body.”<sup>122</sup>

Nevertheless, sharp securities market volatility and uncertainty create temptations anew for fund managers and other fund affiliates. As noted above, many funds experienced substantial investor withdrawals in the early months of the pandemic, while, at the same time, some funds also experienced considerable devaluations, or “drawdowns,” of the value of their portfolio assets as market conditions worsened.<sup>123</sup> Despite these circumstances, the realm of public funds and their managers did not experience pandemic-related litigation to the same extent as in the public company context. This is likely a product of the fact that the public fund context differs from the public company context in two important respects.

First, the net asset value of a public fund’s shares is not determined by whether the fund is able to continue to sell its products or services, produce and supply the medical treatments it is developing, or employ appropriate protocols to keep its customers healthy and safe.<sup>124</sup> Rather, the price of a fund’s shares is typically based on the value of the numerous securities—those issued by *other* funds and companies—comprising its portfolio.<sup>125</sup> During the pandemic,

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122. Carlo di Florio, Dir., Off. of Compliance Inspections & Exams., SEC, Conflicts of Interest and Risk Governance (Oct. 22, 2012). The official’s statement is worth noting in its entirety, as it is one of the SEC staff’s more vivid denunciations of conflicts of interest:

[O]ne can think of ethical concepts as the white blood cells that make an organization’s “immune system”—its compliance and risk management systems and culture—effective. Extending that same metaphor, conflicts of interest can be thought of as the viruses that threaten the organization’s wellbeing. As in the microbial world, these viruses come in a vast array of constantly mutating formats, and if not eliminated or neutralized, even the simplest virus is a mortal threat to the body.

*Id.*

123. *See supra* note 97 and accompanying text.

124. *See, e.g.,* Anita K. Krug, *Investment Company as Instrument: The Limitations of the Corporate Governance Regulatory Paradigm*, 86 S. CAL. L. REV. 263, 298 (2013) (“[A]n investment company’s shares are valued on a daily basis based solely on the value of the securities the investment company holds—rather than the prospects for future appreciation in those shares.”).

125. *Id.*



however, although some funds experienced significant losses, stock prices overall did not reflect the degree of volatility that often spawns significant drawdowns and, beyond that, investor litigation. Indeed, investor lawsuits in the public fund context are more likely to arise when plaintiffs are able to make a reasonable allegation that a fund manager has been led astray in managing the fund's portfolio, such as by deviating from the fund's established (and previously disclosed) investment policies and guidelines.

Second, unlike in the public company context, some of the primary enforcement tools in the investment arena are SEC examinations and investigations, which, in turn, may lead to so-called enforcement actions, which the SEC launches when its investigators uncover inappropriate activity by a fund or a fund manager.<sup>126</sup> This reliance on the SEC as an enforcer is a component of the sweeping regulation to which public funds and their managers are subject.<sup>127</sup> It may also be the cause—or, possibly, the effect—of greater passivity among public fund shareholders, as compared with public company shareholders, in terms of initiating litigation against these entities.<sup>128</sup>

Regardless of the lower rate of public fund litigation arising out of the pandemic as compared to the rate of public company litigation, considering the adversities funds experienced—as well as the SEC's modified manner of conducting investigations during the pandemic<sup>129</sup>—one might question whether any

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126. See Jay Clayton et al., *Statement on the Renaming of the Office of Compliance Inspections and Examinations to the Division of Examinations*, SEC (Dec. 17, 2020), <https://perma.cc/TFM9-KZ5L> (observing that among the SEC's roles is “identifying and monitoring risks, improving industry practices, and identifying and referring misconduct” and that its enforcement function “has promoted a strong culture of compliance within the financial services industry”).

127. See Chen, *supra* note 121 (“Provisions of the Act address requirements for filings, service charges, financial disclosures, and . . . fiduciary duties.”).

128. However, public fund investors do sue fund managers or their boards of directors with some regularity. The point for present purposes is that, perhaps due to alternative enforcement mechanisms in the public fund context, there has been somewhat less litigation arising out of the pandemic's effects on public funds than there has been in the public company context.

129. See OCIE *Statement on Operations and Exams—Health, Safety, Investor Protection and Continued Operations Are Our Priorities*, SEC,

regulatory leniency in this context is appropriate. After all, the discussion above regarding conflicts of interest suggests that the onset of the pandemic may have been an appropriate time for the SEC to impose additional requirements, rather than fewer. To be sure, the agency emphasized to funds and managers the need to be especially diligent during the crisis and to provide timely and material information to investors.<sup>130</sup> Nevertheless, as the next section describes, and reminiscent of the SEC's approach in the public company context, the SEC adopted temporary rules to assist public funds in managing volatility and complying with various regulatory obligations.

### B. *Temporary Rules for Public Funds*

In March 2020, SEC's Division of Investment Management began adopting temporary rules under both the Investment Company Act and the Investment Advisers Act to provide leniency to public funds and fund managers during the pandemic.<sup>131</sup> It did so for the same reasons it adopted rules centered on public companies—to alleviate financial and operational challenges arising from the pandemic. Moreover, as was the case with some of the public company-centered temporary rules, many of the “public fund” rules expired during the summer, after a relatively short period of time.<sup>132</sup> More important, some of these rules were similarly worrisome

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<https://perma.cc/Z82H-58SZ> (last updated Mar. 23, 2020) (“In light of health and safety concerns and other circumstances, OCIE has moved to conducting examinations off-site through correspondence, unless it is absolutely necessary to be on-site.”).

130. See *Importance of Delivering Timely and Material Information to Investment Company Investors*, SEC (Apr. 14, 2020), <https://perma.cc/G5T2-VSRS> (emphasizing “the ongoing importance to update and deliver required information to investors in a timely manner consistent with investment companies’ disclosure obligations, even during this period of operational challenge”).

131. See Jay Clayton et al., *An Update on the Commission’s Targeted Regulatory Relief to Assist Market Participants Affected by COVID-19 and Ensure the Orderly Function of Our Markets*, SEC (June 26, 2020), <https://perma.cc/8YFT-8DPQ> (last updated Jan. 5, 2021) (summarizing the Division of Investment Management’s temporary relief rules for investors, funds, advisers, and service providers).

132. See *id.*

because they softened controls in the securities laws and associated rules to mitigate conflicts of interest that, if acted on, could be harmful to investors.

Similar to the temporary rule pertaining to the public company reporting requirements discussed in Part I, on March 24, 2020, the SEC adopted temporary rules providing an additional forty-five days for public funds to submit certain disclosure reports that were due between March 13, 2020, and June 30, 2020, provided that they were unable to meet a filing deadline because of circumstances relating to COVID-19.<sup>133</sup> Specifically, under these rules a public fund could delay filing its Form N-PORT, a quarterly report requiring disclosure regarding, among other things, a fund's assets and liabilities, securities lending arrangements, recent monthly performance, and investor withdrawals and contributions, and its Form N-CEN, an annual report requiring disclosure of the information reported in an N-PORT plus various other items.<sup>134</sup> In addition, funds were allowed an additional forty-five days to send annual and semi-annual reports to shareholders.<sup>135</sup>

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133. See Order Granting Exemptions from Specified Provisions of the Investment Company Act and Certain Rules Thereunder, 85 Fed. Reg. 15,841, 15,841–42 (Mar. 19, 2020) [hereinafter 2020 Fund Filing Rule] (setting forth the relief and the conditions associated with a fund's reliance on it). Although this rule originally applied only to reports due between March 13, 2020, and April 30, 2020, *see id.* at 15,841, the SEC later extended the end-date to June 30, 2020, *see* Order Granting Exemptions from Specified Provisions of the Investment Company Act and Certain Rules Thereunder, 85 Fed. Reg. 17,611, 17,611 (Mar. 31, 2020) (extending the modifications).

134. See 2020 Fund Filing Rule, *supra* note 133, at 15,842 (stating that a registered fund required to file a N-CEN or N-PORT “is temporarily exempt” from filing the form).

135. See *id.* (requiring, as a condition of the relief, that a public fund relying on it send the relevant report to shareholders “not later than 45 days after the original due date and files the report [with the SEC] within 10 days of its transmission to shareholders”). Like Forms N-PORT and N-CEN, shareholder reports likewise contain extensive information, including information about a fund's portfolio holdings, financial condition, fund expenses, executive compensation, and performance. See Adam Hayes, *Annual Report*, INVESTOPEDIA (Nov. 8, 2020), <https://perma.cc/W3PU-KLCV>. Also relevant for fund managers, in terms of leniency for delaying the distribution of regularly-publicized disclosure, is a March 13, 2020, temporary rule under which all investment advisers—a category that includes fund managers—could delay, by up to forty-five days, the annual update filing and delivery to clients (including any clients that might be public funds) of their

On March 23, 2020, to assist public funds in maintaining sufficient liquid assets to fund withdrawals, the SEC also adopted a set of temporary rules aimed at giving certain public funds greater leniency to borrow money from or lend money to certain affiliates.<sup>136</sup> For any fund, relevant affiliates for these purposes included the fund's manager, directors, and officers but did not include other funds managed by the same fund manager.<sup>137</sup> Under one of these temporary rules, the SEC allowed public funds to borrow money from affiliates other than banks or other public funds, subject to certain conditions.<sup>138</sup>

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Form ADV, which is the key disclosure report required of advisers, regardless of whether they manage public funds. *See* Order Granting Exemptions from Specified Provisions of the Investment Advisers Act and Certain Rules Thereunder, 85 Fed. Reg. 15,829, 15,829 (Mar. 19, 2020) (requiring as a condition of the relief that an investment adviser relying on it file its delayed Form ADV “not later than 45 days after the original due date for filing or delivery, as applicable”). Although this rule originally applied to Form ADV filings that were due on or before April 30, 2020, *see id.*, the SEC later changed the period-end to June 30, 2020, *see* Order Granting Exemptions from Specified Provisions of the Investment Advisers Act and Certain Rules Thereunder, 85 Fed. Reg. 17,609, 17,609 (Mar. 30, 2020) (extending relief to filings due on or before June 30, 2020).

136. *See* Order Granting Exemptions from Specified Provisions of the Investment Company Act and Certain Rules Thereunder, 85 Fed. Reg. 17,374, 17,374 (Mar. 27, 2020) [hereinafter 2020 Borrowing & Lending Rule] (providing, among other things, that, until June 30, 2020, a public fund may “borrow money from any affiliated person, or affiliated person of such affiliated person, that is not a bank and is not itself a registered investment company,” provided it satisfies certain specified conditions).

137. Under Section 2(a)(3) of the Investment Company Act, “affiliated person” (affiliate) of another person includes:

- (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person;
- (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person;
- (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person;
- (D) any officer, director, partner, copartner, or employee of such other person;
- (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof . . . .

15 U.S.C. § 80a-2(3).

138. *See* 2020 Borrowing & Lending Rule, *supra* note 136, at 17,374 (setting forth the relief and the conditions associated with a fund's reliance on it).

Under a second rule, the agency permitted any public fund that was allowed to do so-called interfund lending pursuant to an order previously granted by the SEC to make loans if the value of those loans did not exceed 25 percent of the public fund's net asset value, notwithstanding any lower thresholds in the order, and borrow or lend for any term, notwithstanding conditions in the order limiting the term of the loans.<sup>139</sup> Notably, under a third rule, the SEC made this relief available to certain public funds that had *not* received such an order, permitting them to enter into lending or borrowing transactions without procuring shareholder approval.<sup>140</sup> Finally, to enable funds to take advantage of this relief without violating their governing policies, the SEC permitted public funds to deviate from their standard policies and procedures relating to lending and borrowing.<sup>141</sup> Separate from, but related to, these temporary rules, the SEC provided relief through a so-called no-action letter to permit public funds to sell debt securities to their affiliates to produce liquidity for purposes of funding investor withdrawals.<sup>142</sup>

In the case of public companies, the potential delay of important disclosures permitted by the temporary rules

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139. *See id.* at 17,374–75 (setting forth the rule and the conditions associated with a fund's reliance on it).

140. *See id.* at 17,375 (describing the conditions associated with a fund's reliance on the relief).

141. *See id.* (providing that a public fund could “enter into otherwise lawful lending or borrowing transactions that deviate[d] from any relevant policy recited in its registration statement without prior shareholder approval,” provided its board of directors had approved its doing so, until June 30, 2020).

142. *See* Inv. Co. Inst., SEC No-Action Letter, 2020 WL 1487147 (Mar. 26, 2020), [hereinafter 2020 Debt Security Rule] (providing that the Division of Investment Management staff will not recommend enforcement action against any party that buys a debt security from an affiliated public fund, subject to certain enumerated conditions). It is also worth noting in the context of the SEC's liquidity-focused rules that the agency granted relief whereby a “closed-end” public fund that suffered a decline in net asset value of more than 10 percent due to pandemic-related market conditions was not required to suspend offering shares until it amended its prospectus, as it normally would be required to do. Instead, the fund could continue offering shares as soon as it filed a prospectus supplement discussing the drawdown. *See Division of Investment Management Coronavirus (COVID-19) Response FAQs*, SEC, <https://perma.cc/4N5W-8Y8B> (last updated Nov. 1, 2021) (describing the relief and recommending the inclusion of various disclosures in the supplement).

discussed in Part I is the most troublesome effect of the SEC's pandemic-related temporary rules applicable to public companies. In the public fund context, the potential lag in distributing important information to fund shareholders, the SEC, and the public is equally worrisome. However, for the same reason that investor litigation is more muted in the public fund context—namely, the value of a fund's shares is predominately dependent on the value of the fund's portfolio holdings rather than statements from fund management—delayed disclosure about a public fund is less likely to have a significant impact on the fund's value.

In the public fund context, the more problematic rules are those allowing public funds to enter into borrowing and lending arrangements with their affiliates—arrangements that are otherwise prohibited. Indeed, financial arrangements between a public fund and any of its fund managers or other affiliates represent the fundamental type of conflict that the securities laws seek to mitigate.<sup>143</sup> The worry is especially acute during crisis circumstances, given that such circumstances create significant financial challenges for fund managers and other fund affiliates, which may catalyze conflicts of interest.

To be sure, the pandemic-related temporary rules were subject to meliorative conditions, designed to protect investors and their invested assets. Among other things, the rules as applied to any public fund were generally subject to the determination by the fund's board that entering into a particular arrangement was in the best interest of fund investors.<sup>144</sup> There were also more specific conditions for certain temporary rules. For example, the rule permitting public funds to sell debt securities to affiliates was subject to the condition that the purchase price be paid in cash and that, if the purchaser-affiliate received a profit on resale of the securities, it

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143. This is evidenced by, among other things, the fact that the Investment Company Act prohibits these types of transactions altogether, rather than merely limiting them. *See, e.g.*, 15 U.S.C. § 80a-17(a) (setting forth a list of prohibited transactions between a public fund's affiliates and the fund).

144. *See, e.g.*, 2020 Borrowing & Lending Rule, *supra* note 136, at 17,374 (requiring a board to reasonably determine that borrowing is in the best interest of the fund before it can claim an exemption from section 12(d)(3) of the Investment Company Act).

pay that profit to the seller public fund.<sup>145</sup> Even so, given that “affiliate transactions” are one of the SEC’s signal concerns relating to conflicts of interest, the “borrowing and lending” rules are perhaps the most surprising—and the most problematic—among all the temporary rules that the SEC adopted during the pandemic.<sup>146</sup>

Yet that point begs a larger question. In both the public company and the public fund contexts, the discussions above do not present the full picture, in the sense that they highlight only the more troublesome pandemic-related temporary rules. However, at least some of the temporary rules that the SEC adopted in both contexts provided helpful regulatory leniency without producing problematic “side effects.” Still others may, at some point, be appropriately adopted as permanent rules to create greater regulatory efficiency and unburden enforcement resources, enabling the SEC and other regulators to focus on more damaging behavior. Of course, the rules that Parts I and II describe are limited to those deployed to address the pandemic, which is only one of multiple crises in the past few decades. To evaluate temporary rules more broadly, it is worth reviewing those adopted during past crises. That is the subject of Part III, which additionally proposes that whether a temporary rule is appropriate for the context in which the SEC created it—and the particular crisis challenges it is intended to address—should not depend on ad hoc and anecdotal analysis and judgments.

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145. See 2020 Debt Security Rule, *supra* note 142 (stating that the SEC’s position is based on a number of conditions and listing the conditions).

146. Third-party commentary supports this conclusion. Among others, Erik Gordon, a University of Michigan finance professor, concluded—even apart from the added leniency provided by the temporary rule—that “[t]here are several potential conflicts of interest with interfund lending.” Lewis Braham, *When Funds Lend to One Another*, BARRON’S (Nov. 11, 2017), <https://perma.cc/HH4G-CW5B>. To be clear, these conflicts likely adversely impact the lending fund, rather than the borrowing fund, because the lending fund is “now like the government bailing [the borrowing fund] out” from the risks it assumed. See *id.* Regarding the temporary rule, Rajib Chanda, a partner at Simpson Thacher & Bartlett LLP, stated that “[t]his is pretty extraordinary that the whole mutual-fund industry is able to do this,” presumably on the basis that the rule was unexpected and may have been among the SEC’s more immoderate rules. See Michaels et al., *supra* note 97.

### III. IMPROVING TEMPORARY RULEMAKING

The anecdotes that began this Article illustrate how temporary rules can be potentially damaging to the cause of investor protection. That is not always the case, however. Some temporary rules are desirable because they serve the purpose of alleviating regulatory burdens at times when regulatory compliance is sufficiently challenging that, without such leniency, the subjects of regulation may be at risk of violating relevant rules. At the same time, other temporary rules are desirable because they do the opposite—increase regulatory obligations, whether generally or relating to certain industries or companies.

This Part evaluates the circumstances under which both leniency rules and stringency rules are appropriate and supplies a schema to guide regulators in formulating temporary rules during the next (hopefully distant) crisis. Part III.A sets the framework for this schema by briefly discussing recent “pan-crises”—crises that critically impacted the securities markets on a national scale and possibly on an international scale—and the types of temporary rules the SEC implemented at the time to help address the risks associated with those crises. Part III.B extracts the lessons from these market upheavals to formulate guidance for regulators going forward. This guidance reflects the notion that the types of temporary rules that are appropriate for any particular crisis is partly dependent on the nature of the crisis and the industries most affected by it.

#### A. *Pan-Crises, 1987–2021*

This section describes fairly recent crises and the temporary rules the SEC adopted to help manage each crisis. In doing so, it details how each crisis differed from the most recent one, in terms of the industries that were most affected and the types of rules that were adopted. In chronological order, these are the stock market crash of 1987, the bursting of the “dot-com” bubble in 2001–2002 and simultaneous September 11, 2001, terrorist attacks, the financial crisis of 2007–2009 and, of course, the COVID-19 pandemic of 2020–2021.



## 1. Stock Market Crash of 1987

The most significant events of the 1987 crisis occurred on October 19, 1987, known as “Black Monday.”<sup>147</sup> On that day, the Dow Jones Industrial Average fell by 22.6 percent—a loss that, to date, is the largest one-day market percentage drawdown in history<sup>148</sup>—and global stock exchanges dropped a commensurately significant amount, as market participants worldwide engaged in significant selling.<sup>149</sup> The day also marked the beginning of the first modern-era global financial crisis<sup>150</sup> and led to important market reforms, including a requirement that exchanges develop policies to temporarily halt trading when market sell-offs occur.<sup>151</sup> Finally, the tumultuous events of Black Monday demonstrated that global financial markets were connected to one another to an extent never previously appreciated.<sup>152</sup>

The 1987 market crash was the product of many factors, including the widespread sense among market participants that a long “bear” market was bound to have a correction soon, concerns about higher interest rates, and increased reliance among traders on automated trading.<sup>153</sup> In contrast to later

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147. See Donald Bernhardt & Marshall Eckblad, *Stock Market Crash of 1987*, FED. RSRV. HIST. (Nov. 22, 2013), <https://perma.cc/L4FU-D3UF> (describing how a “chain reaction of market distress” occurring on October 19, 1987, resulted in “the sharpest market downturn in the United States since the Great Depression”).

148. See *id.*; Adam Hayes, *Black Monday*, INVESTOPEDIA, <https://perma.cc/9DRH-S4HQ> (last updated Oct. 31, 2021).

149. See Bernhardt & Eckblad, *supra* note 147 (noting that “[e]ven before US markets opened for trading on Monday morning, stock markets in and around Asia began plunging” and that “[a]dditional investors moved to liquidate positions, and the number of sell orders vastly outnumbered willing buyers near previous prices, creating a cascade in stock markets”).

150. *Id.*

151. See *id.* (discussing these so-called circuit-breakers).

152. See *id.* (“The Black Monday events served to underscore the concept of ‘globalization,’ which was still quite new at the time, by demonstrating the unprecedented extent to which financial markets worldwide had become intertwined and technologically interconnected.”).

153. See *Stock Market Crash of 1987*, INVESTOPEDIA, <https://perma.cc/P4DS-E8R5> (last updated Jan. 22, 2021) (discussing possible causes of the 1987 stock market crash).

significant stock market drawdowns, there is nothing particularly surprising about these factors, and there is no single culprit to blame. As is the case with so many significant market events, the crash was the product of a wildfire-like spread of panic and speculation throughout the markets.<sup>154</sup> More notably, the 1987 crash was the last financial crisis in which the SEC did not adopt any temporary rules, whether of the leniency variety or the stringency variety.

## 2. Dot-Com Bubble and 9/11

The so-called dot-com bubble was a classic market bubble that existed from 1995 to 2001—a period characterized by the tremendous growth and use of the Internet, during which the Nasdaq index quintupled, increasing from 1,000 to 5,000.<sup>155</sup> Its cause was excessive investment in Internet companies (in many cases, regardless of their financial prospects) and these companies' corresponding too-rapid growth.<sup>156</sup> As a result, Internet companies came to have inflated values that, ultimately, could not be sustained.<sup>157</sup> The bubble began to burst in March 2001, but was not fully deflated until late 2002, when the Nasdaq hit 1,139, a 76.81 percent drop from its peak of 5,048 in March 2000.<sup>158</sup>

The burst of the bubble and associated bankruptcy of most Internet companies spawned the onset of a bear market that the September 11, 2001, terrorist attacks only exacerbated.<sup>159</sup> Due

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154. See James Chen, *Stock Market Crash*, INVESTOPEDIA, <https://perma.cc/FS67-WM3H> (last updated Aug. 10, 2021) (noting that stock market crashes are often “largely caused by investor panic”).

155. See Adam Hayes, *Dotcom Bubble*, INVESTOPEDIA, <https://perma.cc/UY8D-8VYD> (last updated June 25, 2019).

156. See D. Quinn Mills, *Who's to Blame for the Bubble?*, HARV. BUS. REV. (May 2001), <https://perma.cc/XW5X-GJKX> (observing that, although “the capital markets did a great job of channeling money into the new business sector that the dot-coms represented,” they nevertheless “did a lousy job of selecting which start-ups to support”).

157. See *id.*

158. See Hayes, *supra* note 155 (describing the impact of the crash on the stock markets).

159. See, e.g., John Miley, *The U.S. Economy Since 9/11*, KIPLINGER (Feb. 3, 2020), <https://perma.cc/W5C5-XR44> (“[T]he events of 9/11 dampened an already weakening economy.”).

to concerns about inevitable panic-induced market selling and a catastrophic loss of market value, the New York Stock Exchange (NYSE) and the Nasdaq did not open on September 11th and remained closed until September 17, 2001.<sup>160</sup> When trading resumed, the Dow Jones fell by 7.1 percent the first day, and, by the end of the week, the Nasdaq had fallen by almost 14 percent.<sup>161</sup>

Despite the one-two punch to the stock market, the SEC did not move to implement any temporary rules until after the latter event. The rules the agency adopted at that point consisted of leniency rules similar to those described above in connection with the pandemic. More specifically, these rules included ones that, through September 28, 2001, allowed public funds to borrow money from affiliates (except other public funds) and entities other than banks,<sup>162</sup> to make interfund loans pursuant to a previously-obtained SEC order valued at up to 25 percent of its net asset value notwithstanding any lower thresholds in the

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160. See Glenn Kessler, *No, President Trump, the NYSE Did Not Open the Day After the Sept. 11 Attacks*, WASH. POST (Oct. 27, 2018), <https://perma.cc/P6LX-N5XJ> (noting that, after September 11, 2001, the U.S. stock markets were “closed until Sept. 17—the longest shutdown since 1933”).

161. See Marc Davis, *How September 11 Affected the U.S. Stock Market*, INVESTOPEEDIA, <https://perma.cc/M769-6573> (last updated Oct. 25, 2021) (summarizing post-September 11, 2001, market volatility). Nevertheless, within a month, the Dow Jones, Nasdaq, and S&P 500 indices had largely recovered and returned to pre-September 11th price levels. See Alexandra Twin, *Wall St. Turns Around*, CNN (Oct. 5, 2001, 5:29 PM), <https://perma.cc/8BAV-SLSA> (detailing U.S. equity indices’ recovery in October 2001).

162. See Order Under the Investment Company Act of 1940 Granting Exemptions from Certain Provisions of the Act and Certain Rules Thereunder, 66 Fed. Reg. 48,721, 48,721–22 (Sept. 21, 2001) [hereinafter 2001 Borrowing & Lending Rule] (setting forth limited relief relating to borrowing from affiliates and non-banks). Although the rule’s effective period was set to expire five business days after the stock markets reopened, the SEC extended its effective period to September 28, 2001. See Order Extending Prior Order Under the Investment Company Act of 1940 Granting Exemptions from Certain Provisions of the Act and Certain Rules Thereunder, 66 Fed. Reg. 49,437, 49,438 (Sept. 27, 2001).

order,<sup>163</sup> and to deviate from their governing policies with respect to borrowing and lending.<sup>164</sup>

Under another temporary rule, the SEC afforded public companies greater ability, through September 28, 2001, to repurchase their own securities,<sup>165</sup> a transaction that is thought to give rise to market manipulation risks.<sup>166</sup> For context, public companies may wish to pursue stock repurchases in volatile market environments for a number of reasons, including that doing so may help maintain the price of their stock, which may be undervalued in these environments.<sup>167</sup> The temporary rule the SEC adopted after September 11th permitted companies to repurchase their own securities—even if the repurchases did not satisfy the requirements of Securities Exchange Act rule 10b-18<sup>168</sup> (which is aimed at preventing manipulative repurchases)—without being deemed to violate relevant antifraud rules.<sup>169</sup>

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163. See 2001 Borrowing & Lending Rule, *supra* note 162 (setting forth limited relief relating to public funds' use of interfund lending arrangements).

164. See *id.* (allowing public funds to enter into borrowing transactions that may “deviate from any relevant policy recited in its registration statement”).

165. See Emergency Order Pursuant to the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, 66 Fed. Reg. 48,494, 48,494 (Sept. 20, 2001) [hereinafter 2001 Repurchase Rule] (setting forth the relief and the conditions associated with a company's reliance on it). Although the rule was to have expired five business days after the stock markets reopened, the SEC extended the effective period to September 28, 2001. See Order Extending Emergency Order Pursuant to the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, 66 Fed. Reg. 49,438, 49,438 (Sept. 27, 2001).

166. See Jerry Useem, *The Stock-Buyback Swindle*, ATLANTIC, <https://perma.cc/E7AJ-NCCU> (last updated July 26, 2019, 2:08 PM) (“[A]nalysis revealed that in the eight days following a buyback announcement, executives on average sold five times as much stock as they had on an ordinary day.”).

167. See *id.* (“By reducing the number of shares outstanding in the market, a buyback lifts the price of each remaining share.”).

168. 17 C.F.R. § 240.10b-18 (2018).

169. See 2001 Repurchase Rule, *supra* note 165 (providing that a public company that has met certain conditions listed in Rule 10b-18 will not be deemed to have violated the Exchange Act's antifraud prohibitions based solely on the time, price, amount purchased, or the brokers or dealers used when repurchases were made).

Beyond these temporary rules, the SEC adopted a few others directed at particular entities or individuals or relating to certain “one-off” circumstances. Under one such rule, the agency granted leniency to the American Stock Exchange in light of its temporary need to use the NYSE’s trading floor after its own was damaged during the September 11th attacks.<sup>170</sup> Another one, directed at all U.S. stock exchanges, extended a previously-issued deadline for the exchanges’ required submissions of certain price-related information.<sup>171</sup>

The overall picture of the agency’s post-September 11th rulemaking, then, is one of measured leniency to help public companies and public funds manage a period of substantial market volatility after the terrorist attacks. To be sure, it did not adopt any temporary rules specifically to temper the impact of the dot-com crash. However, the fact that, at the time of the terrorist attacks, Internet companies were already in a tailspin and having a sizable impact on the market in general arguably contributed to the severity of the post-September 11th volatility that the markets experienced.

### 3. 2007–2009 Financial Crisis

The financial crisis that began in the latter half of 2007 and stretched into 2009 marked the abrupt end of a heady period of cheap credit that allowed speculators and investors to put at risk more capital than they possessed—or could ever pay back, in the event their risk-taking was ultimately unprofitable.<sup>172</sup> Fortunately for them, or so they thought, they would never need

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170. See Emergency Order Pursuant to the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments Concerning the American Stock Exchange, 66 Fed. Reg. 48,493, 48,493 (Sept. 20, 2001) (allowing the Exchange to have specialists serve as floor brokers during the relocation period in light of its temporary relocation and the need for it to operate with limited staffing).

171. See Order Extending the Deadline to Submit Rule Filings Concerning the Implementation of Decimal Pricing in Equity Securities and Options Pursuant to the Securities Exchange Act of 1934, 66 Fed. Reg. 49,983, 49,984 (Oct. 1, 2001) (extending a May 22, 2001, order deadline to January 14, 2002).

172. See Manoj Singh, *The 2007–08 Financial Crisis in Review*, INVESTOPEDIA, <https://perma.cc/9ZJX-ZS7M> (last updated Nov. 27, 2021) (“By the summer of 2007, financial markets around the world were showing signs that the reckoning was overdue for a years-long binge on cheap credit.”).

to pay off their borrowings because there always seemed to be more capital to borrow, allowing them to cover whatever they might eventually owe.<sup>173</sup> However, the worst financial upheaval since the Great Depression ensued, overwhelming the global financial system; bringing down stalwart financial institutions, including Bear Stearns and Lehman Brothers; draining the financial accounts of ordinary individuals; and costing millions of jobs.<sup>174</sup>

Among the primary causes of the crisis<sup>175</sup> were extremely low interest rates that led to a housing bubble worldwide.<sup>176</sup> Home prices rose steeply and quickly as homebuyers took advantage of the low rates and easy-to-get money.<sup>177</sup> In this context, moreover, “homebuyers” included those with low credit ratings, otherwise known as subprime borrowers.<sup>178</sup> This was possible because, by extending credit to these buyers, lenders incurred no risk themselves. Rather, they sold that risk by

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173. This was, in large part, due to government policy. See Christopher Caldwell, Opinion, *Bloomberg Is Right About the 2008 Financial Crash*, N.Y. TIMES (Feb. 15, 2020), <https://perma.cc/2M3C-UVLG>. After the 2001 recession, “both Democratic and Republican leadership” at the national level pursued “reckless government extension of credit,” which, as a policy for addressing economic downturns, had “practical advantages,” including “large, positive, immediate, and widely distributed benefits, whereas the costs all lie in the future.” *Id.*

174. See Singh, *supra* note 172 (describing the effects of the financial crisis on institutions, individuals, and the economy).

175. For a discussion of the role that credit default swaps played in causing the financial crisis, see Anita K. Krug, *Investing and Pretending*, 100 IOWA L. REV. 1559, 1573–77 (2015).

176. See Caldwell, *supra* note 173 (“[The 2007–2009 financial crisis] was brought about by a flawed attempt to use credit markets to broaden access to housing.”).

177. See Paul Davidson et al., *It May Feel Like 2008 All Over Again, But Here’s How the Coronavirus Crisis Is Different*, USA TODAY (Mar. 11, 2020, 12:01 AM), <https://perma.cc/A375-7RCX> (last updated Mar. 11, 2020, 3:17 PM) (observing that the 2007–2009 financial crisis “was set off by an overheated housing market,” in which “[b]anks and other lenders approved mortgages— including many to buyers who weren’t qualified, driving up home prices to stratospheric levels”).

178. See John V. Duca, *Subprime Mortgage Crisis*, FED. RSRV. HIST. (Nov. 22, 2013), <https://perma.cc/93VC-YFNV> (“The subprime mortgage crisis of 2007–10 stemmed from an earlier expansion of mortgage credit, including to borrowers who previously would have had difficulty getting mortgages . . .”).

selling the loans to financial institutions, which “securitized” them—that is, packaged them together into pools of various types of financial instruments, including collateralized debt obligations (CDOs) and other mortgage-backed securities.<sup>179</sup> The sponsoring financial institutions then sold interests in these pools to investors, marketing them as having limited risk (especially the higher-quality segments of the pool), largely because the pools marginalized and diluted the credit risk of any particular subprime borrower.<sup>180</sup> Credit rating agencies’ too-rosy assessments of the risks associated with these securities may have further prompted investors’ eager accumulation of them.<sup>181</sup>

This state of affairs could not last forever, hanging as it did from the slim reed of low interest rates.<sup>182</sup> Additionally, when the downturn came, it was seemingly much worse than most observers had predicted.<sup>183</sup> Neither they nor market participants had adequately accounted for the fact that the same collateral had been used to secure multiple loans system-wide<sup>184</sup>

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179. See Edward J. Schoen, *The 2007–2009 Financial Crisis: An Erosion of Ethics: A Case Study*, 62 J. BUS. ETHICS 805, 813 (2016) (noting that securitizing housing loans into mortgage-backed securities “separated the lender from the risk of default, which was transferred to investors downstream”).

180. See *id.* at 813–14 (“Because the mortgages were pooled, the risk from defaults was spread throughout the pool. . . .”); Liz Moyer, *The Toxic Alphabet Soup that Almost Took Down Wall Street Is Staging a Comeback*, CNBC (Sept. 19, 2018, 7:32 AM), <https://perma.cc/8VJ4-95VV> (last updated Sept. 19, 2018, 8:26 AM) (“CDOs were sold as instruments that could contain risk while providing high income.”);

181. See *The Credit Rating Controversy*, COUNCIL ON FOREIGN RELS., <https://perma.cc/M2NW-XTD5> (last updated Feb. 19, 2015, 7:00 AM) (“Raters deemed many of these structured products top-tier AAA material during the housing boom, only to sharply downgrade them when the housing market collapsed.”).

182. See Singh, *supra* note 172 (detailing the timeline of the 2007–2009 financial crisis).

183. See *id.* (“[F]ew investors suspected that the worst crisis in nearly eight decades was about to engulf the global financial system, bringing Wall Street’s giants to their knees and triggering the Great Recession.”).

184. See Janet L. Yellen, *Interconnectedness and Systemic Risk: Lessons from the Financial Crisis and Policy Implications*, FED. RSRV. BD. (Jan. 4, 2013), <https://perma.cc/4UZ2-87TB> (“At first, the damage appeared to be contained, but the resulting stresses revealed extensive interconnections

or recognized the extent to which counterparties to credit default swaps were tightly bound with one another in interlinking chains of bets such that one large counterparty's need to extricate itself would destroy the whole web and every counterparty comprising it.<sup>185</sup>

These are only some of the factors contributing to the financial crisis. For present purposes, the noteworthy aspect of the crisis is that most of the temporary rules that the SEC adopted at that time were intended not to provide leniency, but rather to prevent additional damage at the hands of those who might aim to profit off of the near-rubble of the financial system.<sup>186</sup> These rules, in other words, were almost exclusively stringency rules, and they almost exclusively revolved around the practice of short-selling.<sup>187</sup>

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among traditional banks, investment houses, and the rapidly growing and less regulated shadow banking sector.”).

185. *See id.*

186. There are a few exceptions to this statement. First, the SEC adopted a temporary rule allowing public companies to repurchase their own securities, *see* Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,588, 73 Fed. Reg. 55,174 (Sept. 24, 2008), which was similar to a temporary rule relating to repurchases that it had adopted during the 2001 crisis, *see supra* notes 126–132 and accompanying text. Second, it adopted a handful of other leniency rules pertaining to financial institutions involved with the credit default swap market. *See, e.g.*, Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions from Sections 5 and 6 of the Exchange Act for Broker-Dealers and Exchanges Effecting Transactions in Credit Default Swaps, Exchange Act Release No. 59,165, 74 Fed. Reg. 133, 135 (Dec. 24, 2008) (granting, among other things, a temporary exemption to exchanges that effected or reported transactions in certain types of credit default swaps from the requirement of registering as a national securities exchange).

187. In a short sale, a trader sells a security that she does not own in the open market, in hopes that the security's price will thereafter decline. *See* Matthew Lewis, *A Transatlantic Dilemma: A Comparative Review of American and British Hedge Fund Regulation*, 22 EMORY INT'L L. REV. 347, 358 (2008). In a “covered” short sale, the trader has borrowed, or arranged to borrow, the security from a broker or others prior to the sale to deliver it to the buyer on the settlement date for the transaction, whereas in a “naked” short sale, the trader will not have done this. *See* Adam Hayes, *Naked Shorting*, INVESTOPEDIA, <https://perma.cc/N54J-TFQQ> (last updated June 1, 2021) (stating that naked short sales involve “selling shares that have not been affirmatively determined to exist”). After some time has elapsed, the trader will buy in the open market the same amount of the same security that she



The first among the set of short-sale rules, which the SEC adopted on July 15, 2008, prohibited most market participants from effecting “naked short sales.”<sup>188</sup> More specifically, the rule, effective through August 12, 2008,<sup>189</sup> prohibited a market participant from executing a short sale involving the securities of a designated institution unless the trader had borrowed or arranged to borrow the relevant security or otherwise “ha[d] the security available in its inventory to borrow” prior to executing the short sale.<sup>190</sup> By requiring market participants to “locate” the relevant securities prior to selling a stock short, the rule ensured that the securities would be available for delivery to the buyer on the settlement date.<sup>191</sup> The SEC believed the rule was necessary based on its assessment that, in light of the events up to then, which included Bear Stearns’s bankruptcy, there was a

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sold (and therefore borrowed) and will give those shares to the lender, to repay her loan. *See* Lewis, *supra* note 187, at 357–59 (describing various hedge fund investment strategies). If all goes well and the security declined in value, the trader’s profit will be the difference between the security’s market price at the time of the sale and the market price at the time the trader later buys the security to return to the lender. *See id.*

188. *See* Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,166, 73 Fed. Reg. 42,379 (July 15, 2008) [hereinafter 2008 Short Sale Rule] (setting forth limitations on effecting short sales). In an amendment to this rule, the SEC excepted market makers and certain other market participants from this prohibition. *See* Amendment to Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,190, 73 Fed. Reg. 42,837, 42,838 (July 18, 2008) (permitting “market makers to facilitate customer orders . . . without possible delays associated with complying with the borrow and arrangement-to-borrow requirement of the Order”).

189. Although the original rule provided that it would expire on July 29, 2008, *see* 2008 Short Sale Rule, *supra* note 188, at 42,379, the SEC later extended the effective period, setting August 12, 2008, as the new expiration date. *See supra* note 128 and accompanying text.

190. *See* 2008 Short Sale Rule, *supra* note 188, at 42,379 (prohibiting short sales of securities in designated financial institutions “unless [the seller] has borrowed or arranged to borrow the security or otherwise has the security available to borrow in its inventory prior to effecting such short sale and delivers the security on settlement date”).

191. *See id.*

significant risk of “sudden and excessive” volatility in the securities markets due to the spread of false rumors.<sup>192</sup>

The SEC followed its short-sale prohibition with additional temporary rules pertaining to short sales, largely based on the same concerns that led it to adopt the rule pertaining to financial institutions.<sup>193</sup> According to the agency, traders continued to take advantage of companies whose financial condition had deteriorated temporarily by inappropriately “shorting” those companies’ securities.<sup>194</sup> The resulting and sudden price declines in these stocks, it noted, could lead to questions about the companies’ financial conditions, in turn causing a possible crisis of confidence that could impair the companies’ viability and further erode confidence in the markets.<sup>195</sup>

Due to these ongoing concerns, the SEC adopted still other temporary rules. First, on September 17, 2008, the SEC effectively expanded the “financial institutions” short-sale rule, which had expired,<sup>196</sup> by adopting another rule covering short sales of the securities of *all* companies, not just financial

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192. *See id.* (observing that the events preceding the sale of Bear Stearns illustrate the dangerous market impact of rumors, that previous SEC actions were intended to disincentivize market manipulation through false rumor dissemination, and that additional action was needed to prevent market disruption).

193. *See* Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,572, 73 Fed. Reg. 54,875 (Sept. 18, 2008) [hereinafter 2008 Enhanced Delivery Requirements Rule] (citing concerns about “unfounded rumors” surrounding the stability of the financial system).

194. *See id.* (observing that the SEC “continues to be concerned that there is a substantial threat of sudden and excessive fluctuations of securities prices” and that “some persons may take advantage of issuers that have become temporarily weakened by current market conditions to engage in inappropriate short selling”).

195. *See id.* (noting that the price declines can “give rise to questions about the underlying financial condition of an issuer, which in turn can create a crisis of confidence without a fundamental underlying basis” that can “impair the liquidity and ultimate viability of an issuer”).

196. *See supra* note 189 and accompanying text.

institutions.<sup>197</sup> In addition, this rule, effective through October 17, 2008,<sup>198</sup> was aimed at a different group of participants in short-sale transactions, namely broker-dealers and participants of registered clearing agencies that assist short sellers in executing their trades.<sup>199</sup> Under the rule's operative provision, any such firm or individual that had a fail-to-deliver position in an equity security at any clearing agency would be subject to a penalty.<sup>200</sup>

Second, at the same time, the SEC adopted a naked short-selling antifraud rule, deeming it a "manipulative or deceptive device or contrivance" for anyone to deceive any participant (including the purchaser) in connection with executing a short sale regarding the trader's ability or intention to deliver the security by the settlement date and then actually fail to deliver the security.<sup>201</sup> Third, on September 18, 2008, the

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197. See 2008 Enhanced Delivery Requirements Rule, *supra* note 193, at 54,876 ("We have concluded that it is necessary to impose enhanced delivery requirements on sales of all equity securities . . .").

198. Originally set to terminate on October 1, 2008, the SEC later extended the effective period to October 17, 2008. See Order Extending Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,711, 73 Fed. Reg. 58,698 (Oct. 1, 2008) [hereinafter 2008 Penalty Rule Extension] ("[E]xtending the Order is in the public interest and necessary to maintain fair and orderly securities markets and for the protection of investors.").

199. See Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,572, 73 Fed. Reg. 54,876 (Sept. 17, 2008). *Id.* at 54,875 ("The temporary rule imposes a penalty on any participant of a registered clearing agency, and any broker-dealer from which it receives trades for clearance and settlement, for having a fail to deliver position at a registered clearing agency in any equity security.").

200. See *id.* (predicting that this "emergency requirement [would] significantly reduce any possibility that 'naked' short selling may contribute to the disruption of markets in these securities"). A participant of a registered clearing agency is an intermediary in making payments or deliveries in a securities transaction. See 15 U.S.C. § 78c(23)(A).

201. Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,572, 73 Fed. Reg. at 54,877. Similar to the "penalty" rule covering broker-dealers or clearing agency participants, see *supra* notes 196–200 and accompanying text, the SEC changed the original termination date of this rule from October 1, 2008, to

agency adopted a new, more sweeping prohibition on short sales directed at financial institutions that prohibited not only naked short sales involving these entities but also all other short sales involving them.<sup>202</sup> This temporary rule, effective through October 2, 2008, included substantially more financial institutions on the no-short list than did its predecessor.<sup>203</sup> Fourth, and also on September 18, 2008, the SEC adopted a temporary rule requiring investment advisers that qualify as “institutional investment managers”<sup>204</sup> to report their short-selling activity to the SEC on a weekly basis through October 17, 2008.<sup>205</sup>

Given the severity of the financial crisis and the nature of the SEC’s post-9/11 temporary rules, one might have expected the agency to have addressed the financial crisis by adopting a range of broadly-applicable temporary rules to assist public companies and public funds as they maneuvered through the

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October 17, 2008. *See* 2008 Penalty Rule Extension, *supra* note 198, at 58,698 (“[E]xtending the Order is in the public interest and necessary to maintain fair and orderly securities markets and for the protection of investors.”).

202. *See* Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,592, 73 Fed. Reg. 55,169, 55,170 (Sept. 18, 2008) (providing that “all persons are prohibited from short selling any publicly traded securities” of any designated financial firm).

203. *See id.* at 55,170 (“Our concerns are no longer limited to the financial institutions that were the subject of the July Emergency Order.”). Although the SEC did not number the institutions on the list either time, the list attached to its July rule release was less than one page, while the one attached to the September rule release was five pages.

204. “Institutional investment managers” are investment advisers who exercise investment discretion over accounts holding securities collectively worth at least \$100 million. 15 U.S.C. § 78m.

205. *See* Securities Exchange Act of 1934; Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,591, 73 Fed. Reg. 55,175, 55,176 (Sept. 18, 2008) (requiring institutional investment managers to report “on the first business day of every calendar week immediately following a week in which it effected short sales”). Although the rule was set to expire on October 2, 2008, *see id.*, the SEC later extended the effective period to October 17, 2008. *See* Amendment to Order and Order Extending Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,724, 73 Fed. Reg. 58,987 (Oct. 2, 2008).

challenging markets. Instead, the agency evinced an almost single-minded focus on preventing opportunistic short selling activities that targeted financial firms, adopting a variety of stringency rules intended to achieve this goal.<sup>206</sup> This approach not only seems to have served market participants' needs at the time; it also provides insights for purposes of discerning a few principles from the agency's temporary rulemaking to date, to guide its future temporary rulemaking.

### B. *Lessons for Temporary Rulemaking*

The discussions above suggest that the need for effective regulation, as well as some leniency, is never greater than in times of crisis. However, some of the SEC's rulemaking to address the circumstances of the pandemic—while undoubtedly providing needed regulatory relief for many public companies and public funds—nevertheless may have exacerbated the risk of fraud. For example, under these rules, public funds affected by market volatility during the pandemic were permitted to enter into borrowing and lending arrangements with affiliates—activities that are otherwise prohibited due to the associated conflicts of interest.<sup>207</sup> Because crises do not abate those conflicts of interest, the risk arises that the terms of any such loan might advantage the lender to the detriment of the borrower or vice versa. In addition, in the public company context, firms could delay making certain public disclosures under certain conditions, allowing investors to remain unaware of critical information for a longer period than they otherwise would.<sup>208</sup>

Risks to investors are especially acute in crisis circumstances.<sup>209</sup> Insofar as the securities markets are concerned, crises are severe episodes of volatility. Public company stock prices often decrease sharply, regardless of the actual financial prospects of the companies at issue, while public

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206. See *supra* notes 186–205 and accompanying text.

207. See *supra* notes 102–107 and accompanying text.

208. See *supra* notes 70–71 and accompanying text.

209. See Adam Hayes, *Investing in Crisis: A High-Risk, High-Reward Strategy*, INVESTOPEDIA, <https://perma.cc/6WBQ-JW8N> (last updated Oct. 28, 2020) (contending that the possibility of a double-dip recession, as well as the uncertainty of a recovery, make investments risky).

funds, whose portfolios largely consist of the securities of public companies, suffer significant decreases in net asset values and investor withdrawals. In these situations, those who manage public companies, as well as managers of public funds, may be tempted to take advantage of weakened firms or affiliated entities (a situation that stringency rules help prevent) or do whatever is feasible to preserve themselves (a situation aided by leniency rules). In effect, crises often force market actors into corners.<sup>210</sup> They do so, however, in different ways and to different degrees, depending on the actors' particular situations.<sup>211</sup>

This insight should inform the SEC's—and, undoubtedly, other regulators'—temporary rulemaking in crisis situations going forward. In the SEC's temporary rule releases and orders to date, the agency has not heeded the ways that the crisis at hand may differ from previous crises. Its failure to do so is evident in its rulemaking after September 11, 2001, as compared with its rulemaking to address the 2020 pandemic, in that some of the temporary rules it adopted during each crisis were substantially similar to one another. Perhaps that is because the crises might likewise seem similar, in the sense that neither of them originated with market upheaval, unlike the 1987 and 2007–2009 crises. Instead, for both crises, cause and effect were reversed: an event unrelated to the markets—terrorist attacks, in one case; and a global pandemic, in the other—caused the market upheaval.

There are significant differences between the two crises—differences that are far more relevant for temporary rulemaking than whether a market downturn was the cause of the crisis or whether it was the effect. A primary one is that, after September 11, 2001, there was no distinction among industries regarding the relative market-related effects of the

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210. See Frederic S. Mishkin, *Anatomy of a Financial Crisis*, 7–12 (Nat'l Bureau of Econ. Rsch. Working Paper No. 3934, 1991), <https://perma.cc/M6CC-4CRY> (listing bank panics, for example, as one such crisis situation).

211. See *id.* at 2–8 (describing how the asymmetrical information available to borrowers and lenders can cause a financial crisis to affect borrowers and lenders to different degrees).

catastrophe.<sup>212</sup> The markets were shut down for days.<sup>213</sup> When they reopened on September 17, 2001, industries broadly shared declines in stock prices<sup>214</sup>—an unsurprising circumstance, given that, at that very early stage, there was much to be determined about the terrorist attacks, including the country’s actions in response to them.<sup>215</sup>

This was not the case during the pandemic, however, because only some industries were directly engaged in the pandemic response. And some industries were more heavily affected by the pandemic than others, as various shareholder class action claims illustrate. Shareholders sought recourse from cruise operators and airlines based on the allegation that the companies did not maintain adequate protocols to protect their customers while publicly claiming otherwise; against health care and pharmaceutical companies based on the allegation that they fraudulently touted developing vaccines, diagnostic tests, and therapeutics that ultimately did not materialize; and against technology companies based on the allegation that they misrepresented their video meeting platform’s adequacy for protecting users’ personal information.<sup>216</sup> In short, from a shareholder risk perspective, some industries during the pandemic were more relevant than others.

This difference between the 2001 and 2020 crises has implications for temporary rulemaking. The rules adopted to address the exigencies of both crises had universal application, in the sense that they applied to all public funds and all public

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212. See Marc Davis, *The Impact of 9/11 on Business*, INVESTOPEDIA, <https://perma.cc/WQ3Q-C4AJ> (last updated July 12, 2021) (“Stock markets immediately nosedived, and almost every sector of the economy was damaged economically.”).

213. Kessler, *supra* note 160.

214. See *id.* (“The market plunged 7 percent [after September 11th].”).

215. For a discussion on the events that transpired on 9/11, see Phillip Zelikow et al., *The 9/11 Commission Report: Final Report of the National Commission on Terrorist Attacks upon the United States*, 9/11 COMM’N (July 22, 2004), <https://perma.cc/E8LK-DHJL> (PDF).

216. See *supra* notes 39–41 and accompanying text.

companies, as the case may be.<sup>217</sup> In the case of the 2020 pandemic, however, the SEC should have weighed the competing interests of helping companies manage the challenges arising from the pandemic, on the one hand, and maintaining, if not bolstering, investor protections, on the other. In other words, crises that affect certain industries more severely than others may necessitate more precision by the SEC in crafting temporary rules. Yet, in 2020, there was no regulatory acknowledgement of the fundamental differences between two disparate crises, separated by eighteen years, each of which created a need for temporary rules.

Temporary *leniency* rules, that is. By contrast, as the 2007–2009 financial crisis was blossoming, the SEC recognized that the adoption of leniency rules was generally not the appropriate approach for addressing the crisis.<sup>218</sup> This was perhaps because, unlike the crisis arising from the 2001 terrorist attacks, the 2007–2009 crisis was caused by market-related factors—namely, the bursting of a credit bubble that had spread far-and-wide throughout the national and international economies.<sup>219</sup> In this context, the SEC aptly discerned that the financial industry was at risk of being taken advantage of, given the viability challenges it was experiencing as a result of having over-leveraged itself.<sup>220</sup> The particular stringency rules that the agency adopted—which largely consisted of restrictions on effecting short sales of the stocks of financial companies—were intended to address the survival risk that companies in this industry were experiencing.<sup>221</sup> Accordingly, unlike the leniency rules the SEC would later

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217. See Clayton et al., *supra* note 131 (describing the temporary relief for public companies in response to COVID-19); *supra* notes 162–166 and accompanying text.

218. See *supra* notes 186–187 and accompanying text.

219. See *supra* notes 175–185 and accompanying text.

220. See 2008 Short Sale Rule, *supra* note 188, at 42,379 (citing the proliferation of rumors that financial institutions were facing liquidity problems as the basis for emergency restrictions on naked short sales); 2008 Enhanced Delivery Requirements Rule, *supra* note 193, at 54,876 (citing the same as the basis for enhanced delivery requirements).

221. See, e.g., 2008 Short Sale Rule, *supra* note 188, at 42,379 (observing that Bear Stearns and other “significant financial institutions” had been subject to the dissemination of false rumors that threatened substantial market disruption).



adopt during the 2020 pandemic, the financial crisis rules also reflected the precision that the agency's 2020 leniency rules lacked, applicable as the latter were to all public companies and all public funds, as the case may be.

Pulling these considerations together, recent crises have demonstrated that the SEC has pursued a course of implementing temporary rules in crisis situations, after having declined to do so in response to the 1987 market crash. Fortunately, although events constituting "crises" have not frequently arisen since then, the ones that have arisen have presented a mix of circumstances that lend themselves to evaluating how the SEC has approached crisis-related temporary rulemaking. That they do so opens the path to formulating guidelines for temporary rulemaking in the context of crises yet to come. The primary guideline that the agency ought to heed in future crisis situations is to formulate rules based on the unique circumstances of specific industries affected by the crisis at issue. Although it did so during the 2007–2009 financial crisis by adopting stringency rules designed to protect financial institutions—which were not only a significant contributor to the occurrence of the crisis but were also suffering the most from it—it failed to do so in enacting leniency rules to aid companies struggling from market upheaval during the 2020 pandemic. However, the pandemic makes evident that the need for precision, for balancing interests, may be necessary in both leniency and stringency contexts.

This should not be surprising. Recall that leniency rules, including those enacted during the pandemic, provide exceptions to or modifications of particular regulatory strictures to alleviate regulatory challenges that may otherwise subject companies and funds to regulatory penalties.<sup>222</sup> In non-crisis circumstances, these penalties might be imposed, for example, if an entity is unable to file reports in a timely manner or, in the case of a public fund, if it lacks sufficient capital to fund investor withdrawals.<sup>223</sup> Presumably the same types of considerations should inform how both stringency rules and leniency rules are formulated. In the leniency context, the question should be which industries, or even companies, should be *excepted* from

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222. See *supra* notes 131–135 and accompanying text.

223. See *supra* notes 136–138 and accompanying text.

the rule (for example, the travel industry or the pharmaceutical and health care industry in 2020). In the stringency context, the question should be—and, as the financial crisis demonstrates, has been—which industries should the rules specifically *target* (for example, the financial industry in 2008). There is nothing about leniency rules that precludes more targeted application, and, indeed, the nature of rulemaking amid a crisis arguably requires it, given the different circumstances surrounding each crisis and each market participant.

#### IV. EXPERIMENTAL TEMPORARY RULES

The previous Parts of this Article explore the stringency and leniency temporary rules that the SEC adopted during significant recent market crises and how such rules may be made more protective of investors in future crises. Yet crisis-related temporary rules not only present challenges to the cause of investor protection. As this Part discusses, they present opportunities, as well.

All temporary rules—those in both the public company context and the public fund context—are intended to enable firms and funds to successfully navigate the myriad difficulties arising from the relevant crisis. However, perhaps surprisingly, some of these rules are more effective than those they were temporarily enacted to override. Accordingly, as challenging as crises are for market participants, they also provide a stage for regulatory experimentation and, possibly, improvement. Part IV.A sets forth some of the temporary rules adopted during the pandemic that continue to enhance certain market participants' operations, while Part IV.B contends that these temporary rules, which promote greater efficiency in an inefficient securities regulatory system, should permanently replace their “overridden” counterparts.

##### A. *Efficiency-Enhancing Rulemaking*

At the same time that city and statewide “lockdowns” spread across the United States and internationally, the SEC recognized that certain requirements under the securities laws and its associated rules were not appropriate, given social distancing and lockdown mandates. Indeed, compliance with some requirements was simply not possible. Eliminating this

impossible situation was the basis of the SEC's adoption of a number of temporary rules during the pandemic.

One of the “more problematic” requirements provides that it is unlawful for a public fund's board of directors to enter into an agreement for the provision of fund management or underwriting services to a public fund unless a majority of the board's independent directors has approved the agreement at an *in-person* board meeting.<sup>224</sup> This requirement, contained in the Investment Company Act, dates back to the 1940 enactment of the statute.<sup>225</sup> Similarly, the statute provides that a public fund's board of directors must approve the fund's independent auditor at an in-person board meeting.<sup>226</sup> Further, pursuant to an SEC rule under the Investment Company Act, an entity may serve as fund manager of a public fund under an interim management agreement only if the interim agreement has been approved by a majority of the board's independent directors at an in-person board meeting before termination of the previous agreement.<sup>227</sup> Finally, under another SEC rule, which is applicable only to so-called open-end public funds, a public fund may act as a “distributor” of its own shares—meaning that it may compensate other parties out of its own assets for marketing and promoting its shares—only if, among other things, the distribution plan and all associated agreements have been approved by a majority of the board of directors at, yes, an in-person board meeting.<sup>228</sup>

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224. See 15 U.S.C. § 80a-15(c) (requiring that a public fund board of directors approve a fund management agreement or an underwriting agreement “in person at a meeting called for the purpose of voting on such approval”).

225. See *id.* (enacted Aug. 22, 1940).

226. See *id.* (requiring that a public fund board of directors select the fund's independent public accountant “in person at a meeting called for the purpose of voting on such approval”).

227. See 17 C.F.R. § 270.15a-4(b)(2)(ii) (2021) (providing that, to appoint an interim fund manager, a public fund board of directors must meet “in person to approve the interim contract before the previous contract is terminated”).

228. See 17 C.F.R. § 270.12b-1(b)(2) (2021) (providing that a public fund may serve as the distributor of the shares that it issues, provided that its board of directors has approved the distribution plan and associated agreements “in person at a meeting called for the purpose of voting on such plan or agreements”).

For most public funds, the SEC's rules require that, even after the board of directors initially approves a public fund's management agreement and its distribution plan and associated agreements, those critical items must be reapproved on an annual basis.<sup>229</sup> Given these requirements, the boards of most public funds include these processes as agenda items for their quarterly board meetings once a year.<sup>230</sup> As a result, even had the pandemic's wrath endured for only a month or two, temporary relief for public funds and their boards regarding in-person meeting requirements was critical.

In response, the SEC adopted temporary rules under which fund boards were relieved from the in-person meeting requirements described above until August 15, 2020,<sup>231</sup> with the agency later extending the effective period to December 31, 2020,<sup>232</sup> and then indefinitely.<sup>233</sup> The conditions for a board's

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229. See 17 C.F.R. § 270.15a-2 (2021) (providing that a fund management agreement must be approved annually after the initial two years); 17 C.F.R. § 270.12b-1(b)(2) (2021) (requiring that a fund's distribution plan and associated agreements be approved in person on an annual basis).

230. See FIDELITY INVS., ANNUAL REPORT 44 (2021) ("Each year, the Board of Trustees, including the Independent Trustees (together, the Board), votes on the renewal of the management contract with Fidelity Management & Research Company LLC (FMR) and the sub-advisory agreements (together, the Advisory Contracts) for the fund."); BLACKROCK, 2020 ANNUAL REPORT 21 (2020) ("BlackRock also manages its US mutual funds, closed-end and exchange-traded funds under management contracts that must be renewed and approved annually by the funds' respective boards of directors, a majority of whom are independent from the Company.").

231. See Order Under Section 6(c) and Section 38(a) of the Investment Company Act of 1940 Granting Exemptions from Specified Provisions of the Investment Company Act and Certain Rules Thereunder; Commission Statement Regarding Prospectus Delivery, Investment Company Act Release No. 33,824, 85 Fed. Reg. 17,611, 17,612 (Mar. 30, 2020) [hereinafter 2020 Board Meeting Rule] (providing a suspension of in-person board meeting requirements under the Investment Company Act and associated SEC rules).

232. See Order Under Section 6(c) and Section 38(a) of the Investment Company Act of 1940 Granting Exemptions from Sections 15(c) and 32(a) of the Investment Company Act and Rules 12b-1(b)(2) and 15a-4(b)(2)(ii) Thereunder, Investment Company Act Release No. 33,897, 85 Fed. Reg. 38,467, 38,468 (June 26, 2020) (providing that the temporary relief from the in-person voting requirement would terminate "no earlier than December 31, 2020").

233. See Jay Clayton et al., *An Update on the Commission's Targeted Regulatory Relief to Assist Market Participants Affected by COVID-19 and*

reliance on these rules are that the reliance is necessary because of circumstances related to COVID-19; the board casts votes that must otherwise be cast at an in-person meeting instead using a means of communication that permits all directors to hear one another simultaneously; and the board ratifies any actions taken in reliance on the temporary rule at its next in-person meeting.<sup>234</sup> With this permission, throughout 2020 and into 2021, public fund boards have held their quarterly and special board meetings on online platforms such as Zoom, Google Meet, Microsoft Teams, and others, even when matters otherwise requiring in-person approvals have been on the agenda.

In another set of temporary rules that are less significant, the SEC provided relief to permit public companies and public funds to convey or distribute certain types of requests, forms, and reports via email rather than through physical mailing.<sup>235</sup> Similar to the temporary rules suspending in-person decision-making requirements for public fund boards of directors, these rules are also reflective of the widespread use and reliability of technology that simply did not exist at the time that Congress and the SEC adopted the securities laws and most of the rules under those laws. As such, for the sake of more efficient regulation, it is worth considering whether any of these temporary rules should supplant the ones they are temporarily suspending.

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*Ensure the Orderly Function of Our Markets*, SEC (June 26, 2020), <https://perma.cc/2MRK-3S8Y> (last updated Jan. 5, 2021) (stating that “[t]he relief will remain in effect until it is terminated by staff action” on the basis that “restrictions and concerns relating to travel are likely to continue for some time”).

234. See 2020 Board Meeting Rule, *supra* note 231 (relaxing the in-person voting requirements).

235. See, e.g., *Division of Corporation Finance Statement Regarding Requirements for Form 144 Paper Filings in Light of COVID-19 Concerns*, SEC (Apr. 10, 2020), <https://perma.cc/22JN-3SVU> (stating that the SEC Division of Corporate Finance would not pursue an enforcement action if Forms 144 “are submitted via email in lieu of mailing or delivering the paper form to the SEC”).

### B. *Toward Better (Permanent) Regulation*

This Article has argued that the SEC's temporary rulemaking during times of crisis is worthy of scholarly attention. That the topic has largely been ignored is presumably a product of the fact that, although temporary rules are not new, they are also not well-established, with the introduction of leniency rules occurring just in this century, in the wake of the September 11, 2001, terrorist attacks. While some temporary rules adopted to date may have presented risks to investors, others have been welcome and needed aids to market participants.<sup>236</sup> Still others may not be the most impactful among temporary rules in terms of their implications for the regulatory goals of investor protection or capital formation but nevertheless represent a step toward modernizing how public companies and public funds operate.

As the previous section notes regarding one such rule, the SEC initially extended the temporary relief it adopted relating to in-person public fund board meetings to the end of 2020.<sup>237</sup> By that point, most public fund boards had likely experienced at least three quarterly board meetings using online platforms.<sup>238</sup> Based on those experiences, it had become overwhelmingly apparent—if doubt previously existed—that online meetings are as effective as in-person ones in terms of voting procedures and permitting robust discussions, full presentations of information,

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236. See Clayton & Hinman, *supra* note 24 (explaining that the SEC's goals are to protect investors and market integrity).

237. See *supra* note 232 and accompanying text.

238. This is because public fund boards of directors are expected to meet at least quarterly. See 17 C.F.R. § 270.0-1(a)(7) (2021) (providing that a public fund satisfies the “fund governance standards” (a defined term) if, among other things, “[t]he disinterested directors meet at least once quarterly in a session at which no directors who are interested persons of the fund are present”). Most public funds comply with these governance standards because such compliance is a condition of the funds' reliance on certain exemptive rules under the Investment Company Act. See, e.g., *Investment Company Governance*, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,377 (Aug. 2, 2004) (to be codified in scattered sections of 17 C.F.R. § 270) (amending certain exemptive rules to include compliance with the fund governance standards as a condition). Most public funds rely on these rules. See Gregory S. Rowland & Sarah E. Kim, *USA, in PUBLIC INVESTMENT FUNDS 2020*, at 120, 122 (3d ed. 2020), <https://perma.cc/483L-UEVP> (PDF).

and thoughtful discussion. Not only are online meetings equally effective, but the costs of these meetings are substantially lower, given that funds do not need to provide reimbursements for travel costs (which benefits fund investors because it is the fund that pays for these travel costs) or incur a number of other expenses.<sup>239</sup> Temporary rules permitting SEC submissions to occur by email, rather than physical delivery, have produced similar benefits.<sup>240</sup>

It is plausible that the agency may decide to adopt some of these temporary rules as permanent ones, as was recommended by its Asset Management Advisory Committee.<sup>241</sup> It has moved in that direction regarding the in-person-meeting relief by extending that rule indefinitely. Its making some rules permanent would be welcome across significant swaths of the public fund arena, as such permanent rules would be a measure of regulatory recognition of the ways that technology has enabled regulatory functions to be performed more efficiently.<sup>242</sup> Securities market participants have largely moved beyond the era of hard copies, physical mailings, faxes, and in-person and telephonic communication, as evidenced by the fact that market transactions now rely heavily on the Internet, automated trading, and electronic communications.<sup>243</sup> It seems appropriate

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239. The author has observed this through personal experience, as she serves on the board of directors of several public funds. These boards have had numerous online meetings since March 2020.

240. See *Division of Corporation Finance Statement Regarding Requirements for Form 144 Paper Filings in Light of COVID-19 Concerns*, *supra* note 235 (allowing certain forms to be submitted via email); ARI B. LANIN, 2 CORP. GOVERNANCE: L. & PRAC. § 14.04(c) (2021) (describing the “significant time and cost savings” resulting from online communications such as email and other platforms).

241. See SEC ASSET MGMT. ADVISORY COMM., RECOMMENDATIONS REGARDING COVID-19 OPERATIONAL ISSUES 7 (2020), <https://perma.cc/2BKD-5LPX> (PDF) (“The AMAC recommends that the SEC issue exemptive or interpretive relief to make permanent its existing relief from the in-person voting requirements for mutual funds boards.”).

242. See LANIN, *supra* note 240 (describing the cost and time savings resulting from the use of online platforms).

243. See 1 SEC. ARB. PROC. MANUAL § 5–6 (2020)

The explosive growth of online trading has improved the control investors have over their portfolios. . . . Online trading has grown rapidly, from 37 firms in 1997 to 160 firms in 1999. Over the same

that the regulator for these participants should embrace these technologies as well.

That suggestion may seem obvious, notwithstanding that the SEC, as the United States' securities regulator and primary financial market regulator, seemingly has not sufficiently recognized it to date. More important for present purposes, and for this Article's evaluation of temporary rules deployed by the SEC in crises contexts, is that the temporary rules described above evidence the broader potential of temporary rulemaking. Specifically, they show how temporary rules may supply a different, and possibly more fruitful, approach to the SEC's rulemaking.

At present, the SEC's rulemaking, whether it be to amend an existing rule or to create a new one, comprises a series of steps occurring over several months.<sup>244</sup> Usually, the process is not expeditious. As a first step, the SEC produces a proposed rule release, in which it describes the rationale for the rule change and why it chose the particular approach that it did.<sup>245</sup> It also sets forth the proposed text of the amended rule or new rule.<sup>246</sup> Importantly, another component of the proposal is an economic analysis, in which the SEC estimates the cost of compliance for different-sized firms and discusses any projected

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period, the number of trading accounts at online broker dealers have also increased significantly. The [General Accounting Office] Report found that the number of accounts more than doubled from about 4.1 million accounts in the last quarter of 1997 to nearly 10.5 million by mid-1999. There has also been a dramatic growth in the number of average daily trades by online investors. The Report found that in the last quarter of 1997, the number of online trades averaged about 153,000 a day, increasing to about 500,000 trades a day by March 1999.

244. See Reporting Threshold for Institutional Investment Managers, Exchange Act Release No. 89,290, 85 Fed. Reg. 46,016, 46,016-20 (July 31, 2020) (to be codified at 17 C.F.R. pts. 240, 249) [hereinafter Example Rule Proposal] (describing the SEC's rulemaking process).

245. For an example of how the agency approaches rule proposals, see *id.* (setting forth the background for the proposed rule).

246. See *id.* at 46,031-32. This is consistent with the requirements of the Administrative Procedure Act. See 5 U.S.C. § 553(b)(3) (providing that agencies must include "either the terms or substance of the proposed rule or a description of the subjects and issues involved" in their general notice of rulemaking).



benefits to regulated parties, among other things.<sup>247</sup> As required by the Administrative Procedure Act,<sup>248</sup> the release additionally announces a comment period, during which potentially affected market participants are able to provide input regarding the proposal and, as appropriate, suggest possible changes to it.<sup>249</sup> Finally, after the comment period has expired, the SEC publishes a final rule release, setting forth the final rule amendment or new rule, restating why it is necessary, and summarizing and addressing the comments it received regarding its proposal.<sup>250</sup>

This procedure is thorough and accords with applicable standards and requirements.<sup>251</sup> Nevertheless, one may reasonably suspect that the SEC's procedures for evaluating whether it is appropriate to pursue formal rulemaking under these standards and requirements is a fraught process, impacted by the quantity and importance of competing rulemaking priorities, as well as the natural hesitancy of an agency that, for the most part, leans toward the conservative rather than the adventurous.<sup>252</sup> This is especially so with regard

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247. See Example Rule Proposal, *supra* note 244, at 46,020–25 (setting forth an economic analysis of the proposed rule). The agency's inclusion of this analysis accords with its current guidance on conducting economic analyses in rulemaking processes. See Memorandum from RSFI and OGC on the Current Guidance on Economic Analysis in SEC Rulemaking (Mar. 16, 2012), <https://perma.cc/79Q8-Z54U> (PDF) (describing statutory guidance and executive orders requiring or recommending economic analyses in rulemaking processes).

248. See 5 U.S.C. § 553(c) (“[T]he agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation.”).

249. See Example Rule Proposal, *supra* note 244, at 46,024–30 (requesting comments on questions relating to various aspects of the proposal).

250. Although the SEC has some discretion in the content of its final rule release, the Administrative Procedure Act requires that an agency's announcement of a final rule or rule amendment occur at least thirty days before it takes effect. See 5 U.S.C. § 553(d) (“The required publication or service of a substantive rule shall be made not less than 30 days before its effective date . . .”).

251. See *supra* notes 244–250 and accompanying text.

252. See, e.g., Brushan Akokar, *SEC Commissioner Downplays Bitcoin ETF Chances in 2019 Citing “Arcane” SEC Rules*, COINSPEAKER (Feb. 14, 2019, 11:51 AM), [perma.cc/NG9X-X6ZA](https://perma.cc/NG9X-X6ZA) (last updated Feb. 12, 2020) (referring to the SEC as a “traditionally conservative agency”).

to rules that constitute “background noise”—that is, that pertain to procedures that are seemingly tangential to, or procedural necessities of, more substantive regulatory mandates. The requirements providing that both public companies and public funds file certain forms and distribute certain documents in hard copy or that certain decisions by public fund boards of directors be made by in-person voting fall into this category.<sup>253</sup>

This is the untapped potential of temporary rules. The SEC can do more with temporary rulemaking than alleviate challenging or destructive circumstances during stock market crises. It can adopt temporary rules to allow it to better assess actual costs and benefits of rule changes that may significantly affect market participants but where that fact may not be immediately evident. Temporary rules have the benefit that they can be flexible and malleable, especially because, as the Introduction notes, most of them are not, in fact, rules but instead fall within a varied category of “Other Orders, Notices, and Information.”<sup>254</sup> As such, they generally can be discontinued at any time.<sup>255</sup> And because they actually guide the behavior of market participants while they are in effect, they can produce better data about costs (including additional risks) and benefits than estimates developed in connection with formal rule proposals.<sup>256</sup>

## CONCLUSION

Born of recent crises significantly impacting the securities markets, the SEC’s crisis-related temporary rules have been largely ignored by scholars but are ripe for study. This Article

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253. See *Division of Corporation Finance Statement Regarding Requirements for Form 144 Paper Filings in Light of COVID-19 Concerns*, *supra* note 235 (allowing forms to be submitted via email instead of in hard copy).

254. See *supra* text accompanying notes 18–19.

255. See *supra* text accompanying notes 18–19; see also Clayton et al., *supra* note 233 (stating that the suspension of the in-person meeting requirement “will remain in effect until it is terminated by staff action”).

256. See Clayton & Hinman, *supra* note 24 (stating that the SEC’s responsive “actions have focused on facilitating market function and preserving market integrity, as well as providing guidance and relief to market participants affected by COVID-19”).

constitutes a first step. Taking its analysis further presents myriad areas for refinement and prescription to enable both scholars and market participants to better understand not only what risks temporary rules might present to investors, but also what opportunities they may provide to regulated entities struggling to survive once-in-an-era market volatility and to the cause of more effective and more efficient regulation. It is apparent that temporary rules are multi-faceted.

What makes temporary rules intriguing is that, to date, they have been unusual. They have represented the efforts of an agency that plays a critical role in the markets to try to provide help where, in some cases, the prospect of life as normal seems hopeless.<sup>257</sup> The most interesting aspect of them, moreover, is that they are a pronouncement of aspects of that hopeless world that could most benefit not only market participants, but also the markets themselves. They are a diagnosis of an ailment; as such, they provide clarity and some measure of understanding.

Perhaps because, in many cases, temporary rules are adopted at early stages based on unavoidably incomplete information—after all, they appear only when crises overtake—they are not perfect. Public company temporary rules, intended to provide regulatory relief in crisis contexts, have served to delay the dissemination of information to the public, thereby possibly impeding the correction of previously-made untruthful statements and extending the period during which investors are relying on misinformation.<sup>258</sup> Temporary rules applicable to public funds, also of the leniency variety, have provided limited permission for fund managers to possibly act on conflicts of interest in formulating lending arrangements between the funds they manage and affiliated

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257. See *supra* notes 17–20 and accompanying text.

258. See Clayton & Hinman, *supra* note 24

This request that companies strive to provide, and update and supplement, as much forward-looking information as is practicable is driven by three primary considerations: (1) the information will benefit investors, (2) market digestion of the information will benefit the company, and (3) the broad dissemination and exchange of firm-specific plans for addressing the effects of COVID-19 under various scenarios will substantially contribute to our nation's collective effort to fight and recover from COVID-19.

entities.<sup>259</sup> At the same time, some temporary rules, particularly those that the SEC adopted amid the 2007–2009 financial crisis to restrict short sales of the securities of financial institutions—and, ultimately, all public companies—have helped save vulnerable industries from falling to traders seeking to take advantage of that vulnerability.<sup>260</sup>

Going forward, to avoid concerns similar to those associated with the SEC's pandemic rulemaking that this Article has identified, the SEC should heed the lesson that arises from the pandemic and other recent crises. During crisis conditions, not all industries and firms should receive the same leniency, depending on their relationship to and involvement with the crisis at issue. In addition, not all market crises originate from tumultuous market events, as the crises stemming from the September 11, 2001, terrorist attacks and the 2020 pandemic demonstrate. In short—and taking a cue from the 2007–2009 financial crisis, in which the SEC focused on the financial industry in connection with its stringency rules—the precision the SEC has used in formulating stringency rules is also necessary in formulating leniency rules, perhaps especially in the context of crises that were not caused by market events.

Still other temporary rules have been innocuous, by all accounts. During the pandemic, for example, the SEC adopted a temporary allowance for public fund boards of directors to meet electronically to make decisions otherwise required to be made during in-person meetings.<sup>261</sup> As a result of this rule, electronic meetings quickly became a staple for conducting business as the pandemic raged on.<sup>262</sup> This and other temporary rules represent another important component of temporary rulemaking: Temporary rules may prove to be not only necessary and welcome in crisis circumstances, but also efficiency-enhancing in non-crisis circumstances and, therefore, worthy of consideration for becoming permanent rules that outlast crisis

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259. See 2020 Borrowing & Lending Rule, *supra* note 136, at 17,374 (allowing public funds to borrow from affiliated entities).

260. See 2008 Short Sale Rule, *supra* note 188, at 42,379 (limiting short sales).

261. See 2020 Board Meeting Rule, *supra* note 231, 17,612 (eliminating the requirement for in-person meetings).

262. See LANIN, *supra* note 240 (describing the rise of virtual meetings and platforms to facilitate corporate communications).

conditions. More broadly, these rules show how crisis-related temporary rules may be used as regulatory experiments that could improve regulation in crises and beyond. Whether that happens remains to be seen, but one hopes at least that renewed focus on the “temporary” component of securities regulation will inform all of the possibilities.