INSIGHTS

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INSIDE THE SEC

Highlights from the 39th Annual Securities Regulation Institute

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The 39th Annual Securities Regulation Institute, sponsored by Northwestern University School of Law, was held on January 18 through January 20, 2012, in Coronado, California. The panels at the Institute discussed a number of different topics, and included judges, SEC directors, professors, and practitioners. They provided insights into SEC activity and expected judicial trends in both corporate and enforcement proceedings, along with practical pointers to avoid recently identified traps and pitfalls for the unwary securities attorney.

Pre-IPO and IPO Execution Matters

On a panel discussing planning for and executing the IPO, the panelists addressed strategies to manage the 500-holder threshold set forth under Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act), including:

- using the exemption provided under Rule 12h-1(f) for compensatory stock options issued under the exemption from registration provided by Rule 701 of the Securities Act of 1933 (Securities Act);
- including rights of first refusal to purchase shares of stock offered on private exchanges or otherwise;[1]
- repurchasing shares from employees (although it was noted that share buybacks may not be the best use of an early growth company's funds and may raise separate issues under Section 409A of the Internal Revenue Code); and
- prohibiting the sale of shares by employees pursuant to an insider trading policy.

The panel also discussed the no-action relief granted to several pre-IPO companies (*e.g.*, Facebook,[2] Zynga,[3] and Twitter[4]) with respect to the registration requirements of Section 12(g). Notwithstanding these prior no-action letters, Shelley Parratt, Deputy Director of the SEC's Division of Corporation Finance, urged issuers to seek their own no-action relief before (rather than after) crossing the 500-holder threshold. In a separate session, Meredith Cross, Director of the SEC's Division of Corporation Finance, explained that the SEC is working on a global no-action letter meant to apply to all companies seeking such relief with respect to restricted stock

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units. (*Editor's note: on February 13, 2012, the Division issued such a no-action letter to Fenwick & West LLP.*)

The panel also discussed the disclosure of "flash" financial results in connection with an IPO following the close of a fiscal period, but prior to the completion of the audit or review for that period. Ms. Parratt noted that while the Staff generally encourages the disclosure of such information in narrow ranges, it may ask the issuer to explain why a specific estimate or narrower range cannot be provided. Another panelist noted that underwriters will need to perform significant diligence on such information, and may even seek a form of "comfort letter" from the issuer, as the issuer's auditors are unlikely to be in a position to provide any comfort.

Corporate Governance/Stockholder Activism

During a panel on corporate governance and stockholder activism, Meredith Cross discussed some of the work streams flowing from the "proxy plumbing" concept release.[5] She explained that the SEC has been spending significant time focusing on the proxy advisory portion of the release. Ms. Cross noted that while the SEC is unable to address issuer frustrations regarding the leverage of proxy advisory firms, the use of such firms raises a number of issues that the SEC is considering addressing. In particular, informed shareholder voting can be impaired in two ways: (1) if conflicts of interest on the part of proxy advisory firms are inadequately disclosed and managed (for example, where the advisory firm is making a recommendation and is also advising the company); or (2) if proxy advisory firms develop, disseminate, and implement their voting recommendations based on materially inaccurate or incomplete data, or flawed analysis.[6]

The panel also discussed the future of proxy access and summarized the aftermath of the *Business Roundtable v. Securities & Exchange Commission*[7] decision vacating Rule 14a-11.[8] Although Ms. Cross expressed the SEC's disappointment with the *Business Roundtable* decision, she noted that the SEC would probably not draft a rule to replace the rescinded Rule 14a-11 due to bandwidth constraints in light of other rulemaking mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). In the interim, due to the amendments to Rule 14a-8 that were not challenged, private ordering will rule the day, and approximately 19 proxy access shareholders proposals already have been submitted for the 2012 proxy season. A few companies have attempted to preempt such proposals by adopting their own proxy access proposals, raising the possibility of excluding stockholder proposals with different thresholds (*e.g.*, a relatively lower requirement of holding only 1 percent of the company's stock for at least one year) based on one of two substantive bases. Alan Beller, former Director of the SEC's Division of Corporation Finance and now partner at Cleary Gottlieb Steen & Hamilton LLP, noted that the bar for excluding these types of proposals on "substantially implemented" grounds under Rule 14a-8(i)(10) would be significantly higher than under the "directly conflicts" with a company proposal provision of Rule 14a-8(i)(9).

Another panel discussed Staff Legal Bulletin 14F dealing with shareholder proposals, which described, among other things, common errors shareholders can avoid when submitting proof of ownership to companies.[9] Ms. Cross noted that the proof of ownership requirements are not meant to be a trap for stockholders, and that companies should be very clear with stockholders regarding alleged deficiencies in their proof of ownership.

The Ever-Expanding Role of the Disclosure Lawyer: Conflict Minerals, Cyber Attacks, and More

A disclosure issues panel discussed the new specialized disclosures required under the

Dodd-Frank Act. Ms. Parratt provided a timeline for Dodd-Frank Act disclosure and corporate governance rulemaking, including:

- ***Compensation Committees and Consultants.*** Directions from the SEC to establish exchange listing standards regarding compensation committee independence and factors affecting compensation advisor independence, and disclosure rules regarding compensation consultants are anticipated to be adopted by June 2012.[10] In a subsequent panel, Meredith Cross explained that the SEC will hew closely to the requirements of the Dodd-Frank Act[11] (rather than rely on currently existing rules) and will leave additional rulemaking to the exchanges.
- ***Executive Compensation.*** Rules regarding disclosure of pay-for-performance, pay ratios and hedging by employees and directors, and rules regarding listing standards related to the clawback of executive compensation are anticipated to be proposed by June 2012 and adopted by December 2012.

The panel addressed a number of other "hot topic" disclosures including exposure to European sovereign debt,[12] climate change, mine safety, loss contingencies, and, as described below, conflict minerals and cybersecurity risks.

One panelist noted that issuers subject to the new conflict mineral disclosure rules will need to coordinate with their upstream suppliers and downstream buyers well in advance of assembling their Form 10-K disclosures.[13] It was noted that the proposed conflict minerals rules are anticipated to be adopted by June 2012.

The panel also addressed recently promulgated disclosure guidance on cybersecurity risks and cyber incidents.[14] Ms. Parratt stressed that the federal securities laws do not require disclosures that provide a "roadmap" of a company's network security; rather, companies should provide sufficient disclosure to allow investors to appreciate the nature of the risks faced by the particular registrant in a manner that would not set forth such a "roadmap."[15]

The panel discussed the increased use of non-GAAP financial measures, and the Staff's non-GAAP Compliance & Disclosure Interpretations.[16] On this front, Ms. Parratt specifically noted that the SEC Staff is comparing companies' earnings releases and presentations against their SEC-filed documents, and are looking for consistency in disclosure. Notably, the SEC does not require that all non-GAAP financial measures used in earnings releases be filed with the SEC. Nevertheless, companies must remain sensitive to general disclosure obligations and the reconciliation requirements of Regulation G. Finally, Ms. Parratt reminded the audience that the SEC could comment on excessive non-GAAP financial information disclosure (*e.g.*, a full non-GAAP income statement).[17]

Accounting Discussion

The accounting panel discussed a number of issues, including the complexities of IPO accounting, the differences between gross and net revenues, and the landmines of auditor independence. The panel explained certain standards promulgated by the Financial Accounting Standards Board governing loss contingencies.[18] Beginning with 2010 annual reports, many financial institutions received comment letters seeking clarification of disclosures required for losses that were reasonably possible to be realized, and where a reasonable estimate could be provided for the amount of losses. These financial institutions have since estimated and quantified such losses. As the SEC seeks improved disclosure under current standards, the Financial Accounting Standards Board (FASB) has placed its revision process on hold for the time being.[19]

M&A Trends and Developments

A panel that included Chancellor Leo Strine of the Delaware Court of Chancery discussed the mergers and acquisitions (M&A) marketplace,

the role of private equity buyers, the recent *In re Southern Peru Copper Corp. Shareholder Derivative Litigation*[20] decision, the allocation of antitrust risks in M&A transactions, and a number of helpful practice pointers.

In discussing of the role of investment bankers and investment banker conflicts, Chancellor Strine noted the peculiar evolution of fairness opinion practice: the primary advisory bank may have a detailed historical understanding of the seller and its business, and would therefore be well-positioned to provide a valuable fairness opinion to the board, but a different independent financial advisor will often instead provide the fairness opinion, after performing two weeks' worth of diligence. Chancellor Strine noted that the Delaware courts don't "fetishize" the words contained in fairness opinions, but rather look towards the process that led to the opinion, including whether a proper market analysis and market check had been performed by the bank.

Another panelist noted that engaging multiple investment banks to render opinions could result in competing and contradicting disclosures in the proxy statement, providing rich fodder for plaintiffs' counsel.

Enforcement and Criminal Investigations

Robert Khuzami, Director of the SEC's Division of Enforcement, led off the enforcement and criminal investigations panel with the Enforcement highlights of 2011 and expectations for 2012. The Division of Enforcement's restructuring in 2009 and 2010 resulted in five separate segments. Overall, an entire layer of managers had been eliminated, resulting in a doubling of the ratio of staff to managers. The Division is actively using metrics to measure the staleness and timelines of cases, primarily in order to track how quickly cases are resolved. While the Division currently has a national priority list of cases, it is trying to develop qualitative metrics to measure the importance of those cases.[21]

The panel discussed a number of recent developments in the enforcement of the Foreign Corrupt Practices Act. Debra Yang, former United States Attorney for the Central District of California and partner at Gibson Dunn, noted regulators' increased focus on holding individuals, and not just corporations, accountable. Ms. Yang described how two ongoing Los Angeles-based cases are considering the same issue of what constitutes a "foreign official." The general factors considered include: how does the foreign government treat that entity; what obligations and privileges does that entity have under foreign laws; are the entity's employees treated as government officials; and how were the entity's employees held out to the public? While some other countries have adopted new foreign bribery laws or provisions (including the United Kingdom and a multitude of others),[22] most view the United States as the global police force on this front.

Mr. Khuzami concluded the panel with a discussion of the SEC's Office of the Whistleblower, the establishment of which was directed by the Dodd-Frank Act.[23] In the first seven weeks after the SEC's whistleblower rules became effective, the Office received 334 qualifying tips.[24] Mr. Khuzami explained that of these tips, the Staff pursued only those complaints that would be most appropriate for independent investigation. Consequently, some whistleblower tips that were less appropriate for independent investigation were reported back to the companies from which they originated.

Federal and State Judicial Developments

The federal and state judicial developments panel reviewed a number of recent judicial opinions and their potential effects. The panelists discussed how the primary holding of *Wal-Mart Stores, Inc. v. Dukes*[25]—that class certification is proper if it generates common answers to the resolution of the litigation—may affect securities class action lawsuits.[26] Since *Wal-Mart*, numerous motions to decertify classes have been filed, each

generally arguing that the defendant should be able to explore individualized defenses to plaintiffs' claims. The panelists, however, expressed some concern that to the extent *Wal-Mart* increased the difficulty of certifying a class, companies would not be able to "purchase their peace" with securities class action settlements (a requisite portion of which is the certification of the class).[27]

The panel also touched on *AT&T Mobility LLC v. Concepcion*,[28] noting that the willingness of the Supreme Court of the United States to enforce an arbitration clause in resolving a consumer dispute has already affected the provisions of at least one limited partnership agreement: Carlyle Group LP (Carlyle), the Washington-based buyout company preparing to go public, sought to bar its future unitholders from filing individual and class-action lawsuits.[29] However, after consultations with the SEC, Carlyle announced its plans to withdraw the proposed arbitration provision.[30]

Myron Steele, Chief Justice of the Delaware Supreme Court, presented his views on a number of other cases and issues. In discussing fiduciary duties in the context of limited liability companies (LLCs), Chief Justice Steele explained how the Delaware Limited Liability Company Act could be read so that the default rule for LLCs is that no fiduciary duties exist beyond those that are expressly contracted for.[31] Stuart Grant, partner of Grant & Eisenhofer P.A., noted that there are approximately 85 publicly listed LLCs, and that the lack of default fiduciary duties (or the ability to contractually eliminate fiduciary duties), coupled with the mandatory arbitration provisions described above, could result in a true race to the bottom—potentially requiring future federal or state legislative intervention.

Notes

1. *See, e.g.*, Pui-Wing Tam & Geoffrey A. Fowler, *Hot Trade in Private Shares of Facebook*, Wall St. J. (Dec. 28, 2010), *http://online.wsj.com/article/SB10001424052970204685004576045943100180026.*html (describing Facebook's option to either repurchase the stock itself or find another buyer within 30 days).

2. Facebook, Inc., SEC No-Action Letter, 2008 SEC No-Act. LEXIS 574 (Oct. 14, 2008).

3. Zynga Inc., SEC No-Action Letter, 2011 SEC No-Act. LEXIS 415 (June 17, 2011).

4. Twitter, Inc., SEC No-Action Letter, 2011 SEC No-Act. LEXIS 482 (Sept. 13, 2011).

5. Concept Release on the U.S. Proxy System, Exchange Act Release No. 62495, Investment Company Act No. 29340, 75 Fed. Reg. 42982 (July 22, 2010).

6. *Id.* at 43011.

7. 647 F.3d 1144 (D.C. Cir. 2011). The United States Court of Appeals for the District of Columbia Circuit issued an order vacating Rule 14a-11 on July 22, 2011, and issued its mandate concluding the litigation on September 14, 2011.

8. Facilitating Shareholder Director Nominations, Securities Act Release No. 9259, Exchange Act Release No. 65343, Investment Company Act Release No. 29788, 2011 SEC LEXIS 3212 (Sept. 15, 2011) ("The Court's order did not affect the amendment to Rule 14a-8, which was not challenged in the litigation, or the related rules and amendments adopted concurrently with Rule 14a-11 and the amendment to Rule 14a-8. Accordingly, those rules and amendments are effective upon publication of this notice in the Federal Register.").

9. Corporate Fin. Div., U.S. Sec. & Exch. Comm'n, *Shareholder Proposals*, sec.gov (Oct. 18, 2011), *http://www.sec.gov/interps/legal/cfslb14f.htm.*

10. Listing Standards for Compensation Committees, Securities Act Release No. 9199, Exchange Act Release No. 64,149, 76 Fed. Reg. 18,966 (proposed Mar. 30, 2011).

11. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1900–03 (codified in scattered sections of 15 U.S.C. (2010)).

12. *See generally* Corporate Fin. Div., U.S. Sec. & Exch. Comm'n, *CF Disclosure Guidance: Topic No. 4*, sec.gov (Jan. 6, 2012), *http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic4.htm* (providing guidance to SEC registrants regarding disclosures of risks to European sovereign debt holdings).

13. Conflict Minerals, Exchange Act Release No. 63547, 75 Fed. Reg. 80948, 80948 (Dec. 23, 2010).

14. Corporate Fin. Div., U.S. Sec. & Exch. Comm'n, *CF Disclosure Guidance: Topic No. 2*, sec.gov (Oct. 13, 2011), *http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.*

15. *See id.*

16. Corporate Fin. Div., U.S. Sec. & Exch. Comm'n, *Non-GAAP Financial Measures*, sec.gov, *http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm* (last updated July 8, 2011).

17. *See id.* § 1.02.10.

18. *See* Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 5: Accounting for Contingencies (1975).

19. FASB issued an "Exposure Draft" of a proposed accounting standards update on July 20, 2010. Fin. Accounting Standards Bd., Proposed Accounting Standards Update—Contingencies (Topic 450): Disclosure of Certain Loss Contingencies (2010), available at *asc.fasb.org/imageRoot/73/6954873.pdf*. FASB has directed its staff to work with the staffs of the SEC and the Public Company Accounting Oversight Board to understand their efforts in addressing investor concerns about the disclosure of certain loss contingency through increased focus on compliance with existing rules. Loss Contingencies Team, Fin. Accounting Standards Bd., Minutes of November 10, 2010, FASB Board Meeting: Disclosures of Loss Contingencies 2 (2010), available at *http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157929892*.

20. C.A. No. 961-CS, 2011 Del. Ch. LEXIS 160 (Del. Ch. Oct. 14, 2011).

21. *See* Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Enforcement Manual 4–5 (2011).

22. Bribery Act 2010, c. 23 (U.K.), available at *http://www.legislation.gov.uk/ukpga/2010/23/contents*.

23. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1850 (codified in scattered sections of 15 U.S.C. (2010)).

24. U.S. Sec. & Exch. Comm'n, Annual Report on the Dodd-Frank Whistleblower Program 5 (2011), *http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf*.

25. 131 S. Ct. 2541 (2011).

26. *See id*. at 2551 (quoting Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. Rev. 97, 132 (2009)).

27. *See, e.g.*, *In re Wash. Mut. Mortgage-Backed Sec. Litig.*, No. C09-37 MJP, 2011 U.S. Dist. LEXIS 123946 (W.D. Wash. Oct. 21, 2011); *Pub. Emps.' Ret. Sys. of Miss. v. Merrill Lynch & Co.*, 714 F. Supp. 2d 475 (S.D.N.Y. 2010) (ruling on a securities class action claiming that offering documents were false and misleading); *Ehrenhaus v. Baker*, 717 S.E.2d 9 (N.C. Ct. App. 2011) (distinguishing the facts of *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011)).

28. 131 S. Ct. 1740 (2011).

29. Miles Weiss, *Carlyle Seeks to Ban Shareholder Lawsuits Before Public Offering*, Bloomberg.com (Jan. 17, 2012 9:01 PM), *http://www.bloomberg.com/news/2012-01-18/carlyle-seeks-to-ban-shareholder-lawsuits-before-initial-public-offering.html* (quoting John Olson, a partner of Gibson Dunn, that "publicly traded limited partnerships have also been granted more leeway than corporations in restricting the ability of investors to make claims"); *see* The Carlyle Grp. L.P., Pre-Effective Amendment to Registration Statement (Form S-1/A) (Jan. 10, 2012).

30. Miles Weiss, Jesse Hamilton, & Cristina Alesci, *Carlyle Drops Class-Action Lawsuit Ban*, Bloomberg.com (Feb. 3, 2012, 1:15 PM), *http://www.bloomberg.com/news/2012-02-03/carlyle-drops-class-action-lawsuit-ban.html*.

31. *See* Del. Code Ann. tit. 6, § 18-1101(c), (e) (2011). For further discussion of the appropriate default position, *see* Widener Law, *On-Line Symposium: Default Fiduciary Duties in LLCs and LPs*, blogs.law.widener.edu/delcorp, *http://blogs.law.widener.edu/delcorp/on-line-symposium-default-fiduciary-duties-in-llcs-and-lps/* (last visited Feb. 5, 2012).