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INSIDE THE SEC

Highlights from the San Diego Securities Regulation Institute

By James Moloney and Michael Titera

The 41st Annual Securities Regulation Institute (Institute), sponsored by Northwestern University School of Law, was held January 27th through January 29th, 2014, in Coronado, California. The panels at the Institute covered a number of topics, including the Jumpstart Our Business Startups Act of 2012 (JOBS Act) developments, Securities and Exchange Commission (SEC) disclosure review and rulemaking initiatives, SEC enforcement and criminal investigations, shareholder activism and corporate governance, and mergers and acquisitions developments. Speakers and panelists at the Institute included senior SEC staff, including SEC Chair Mary Jo White, former Delaware Supreme Court Justice Myron T. Steele, and practitioners.

Keynote Address

Chair White's address touched on the SEC's technology initiatives, current rulemakings, and enforcement priorities, among other topics. She highlighted two new tools the SEC is using to keep pace with evolving technology. First, the new National Exam Analytics Tool (NEAT) allows examiners to access and systematically analyze massive amounts of trading data quickly to identify signs of insider trading, front running, window dressing, improper allocations of investment opportunities, and other misconduct. Second, the Market Information Data Analytics System (MIDAS) enables the SEC to collect and sift through tremendous amounts of trading data across markets "instantaneously."[1]

Regarding disclosure reform and the review of Regulation S-K mandated by the JOBS Act, Chair White made clear that she intends to have the SEC conduct a thoughtful and comprehensive review of the rules that goes beyond simply identifying particular requirements that can be eliminated or modified. She stated: "I believe we should rethink not only the type of information we ask companies to disclose, but also how that information is presented, where and how that information is disclosed, and how we can take advantage of technology to facilitate investors' access to information and make it more meaningful to them." This was a theme addressed throughout the conference by many SEC officials. Chair White indicated that she has asked the staff to begin an active review of the SEC's disclosure rules; however, given the breadth of the undertaking, it is unclear when these reforms may be completed.

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Chair White also indicated that we will see more SEC cases involving admissions in 2014, noting that the parameters of the types of cases in which the SEC will insist on getting admissions of fault or wrongdoing "will continue to evolve and be subject to further articulation."

JOBS Act—IPO Developments

The first panel discussed IPOs and other registered offerings, with a focus on the impact of the JOBS Act, which was an area of emphasis for panels throughout the Institute. Keith F. Higgins, Director of the SEC's Division of Corporation Finance, noted that the provisions permitting confidential submission of IPO draft registration statements have been the most well received aspect of the JOBS Act. Since the JOBS Act was enacted on April 5, 2012, the SEC has received over 400 confidential submissions. Panelists discussed the "shadow pipeline" that has emerged as a result of confidentially submitted draft registration statements and how that has limited visibility into the IPO market. Mr. Higgins also indicated that some companies have taken advantage of the "test the waters" provisions of the JOBS Act. In such cases, the SEC staff has asked to see companies' "test the waters" materials to confirm that they are consistent with the companies' filings.

The panelists discussed various hypothetical situations involving gun-jumping, testing the waters, integration, disclosure policies, and governance and liquidity considerations. With respect to gun-jumping, the panelists generally expressed the view that a general solicitation for a private placement could cause gun-jumping issues if a company does an IPO too close to the general solicitation. With respect to testing the waters, David J. Chen, Managing Director at Morgan Stanley, noted that the provision has not proven to be a particularly useful means of gauging interest in a potential offering or valuing that offering. Moreover, the panelists indicated that many integration issues raised by the JOBS Act remain unsettled.

The discussion of governance and liquidity considerations in IPOs revolved around the potential importance of implementing anti-takeover measures in a company's early years, particularly a dual-class stock structure. Mr. Chen noted that for very strong companies, investment bankers may be able to sustain a dual-class structure in an IPO; however, companies often conclude that it is not worth the time it takes to explain at a roadshow meeting.

Mr. Higgins discussed areas that the SEC continues to focus on when reviewing registration statements. In particular, he indicated that the SEC looks closely at how companies tie the metrics found in their prospectuses to revenue growth and profitability. Mr. Higgins expressed some skepticism about the usefulness of case studies, market statistics, and comparisons in registration statements, noting that these often are not the subject of sufficient diligence. He also indicated that the SEC does not want to see exhaustive detail about valuation methodologies in companies' stock compensation disclosures, as this information tends not to be meaningful to investors in an IPO. While companies need to perform the detailed analyses to arrive at the valuations, they do not need to include their analyses in the filings.

JOBS Act—Private Company Developments

A later panel focused on private company JOBS Act developments. Jonathan A. Ingram, Acting Chief Counsel of the Division of Corporation Finance, began the panel with a discussion of the revisions to Rule 506 under the Securities Act of 1933, focusing on the "bad actor" disqualification provisions in Rule 506(d). He drew attention to two recent Compliance and Disclosure Interpretations (C&DIs) where the SEC addressed questions regarding persons covered under the provisions. Instead of interpreting the term "affiliated issuer" broadly, the SEC chose to interpret it to mean only a co-issuer.[2]

The SEC also clarified that the term "beneficial owner" in Rule 506(d) is interpreted the same way as under Exchange Act Rule 13d-3.[3] Stanley Keller of Edwards Wildman Palmer LLP recommended that law firms revisit their accredited investor questionnaires in light of the SEC's new guidance.

The panelists discussed the new Rule 506(c) provisions, which require an issuer to take "reasonable steps" to verify that purchasers are accredited investors. Mr. Ingram indicated that the verification was intended to be a "principles-based" determination, with the four non-exclusive methods listed in Rule 506(c)(2)(ii)(A)-(B) to be used as safe-harbors in situations where there are not sufficient principles-based factors to make the determination. He expressed surprise that practitioners seem to take the opposite view, relying on the non-exclusive methods in the first instance and viewing the principles-based determination as a safe-harbor in the event none of the non-exclusive methods are met. Multiple panelists expressed their views as to why practitioners have preferred to use one of the four non-exclusive methods as opposed to making the principles-based determination the SEC had intended, with one panelist noting practitioners' apprehension about issuing "no registration" opinions that rely on the practitioners' own determination of whether "reasonable steps" were taken to verify investors accredit investor status. Mr. Keller encouraged practitioners to help develop new practices in this area by making their own principles-based determinations of whether reasonable steps were taken instead of relying solely on the safe-harbors provided by the SEC.

Alan L. Beller of Cleary Gottlieb Steen & Hamilton LLP led a discussion of the changed landscape for unregistered offerings. He discussed factors to consider when counseling clients regarding the use of Rule 506(b) and Rule 506(c) offerings. He recommended that if a company is not sure whether it would prefer the general solicitation aspect of a Rule 506(c) offering or the ability of a Rule 506(b) offering to include up to 35 non-accredited investors, that the company start with a Rule 506(b) offering only to verified accredited investors and without any general solicitation. If the company later decides that it needs to include non-accredited investors, it can continue on the Rule 506(b) path and continue to refrain from general solicitation. However, if the company decides that it would like to engage in general solicitation, it can amend its Form D and switch over to a Rule 506(c) offering and continue accepting only verified accredited investors.

Mr. Ingram discussed the additional revisions to Rule 506 that the SEC proposed in July 2013, which would, among other things, require the advance filing of Form D for Rule 506(c) offerings, require the filing of a Form D closing amendment for Rule 506 offerings, and amend the content requirements of Form D.[4] Mr. Ingram noted that the SEC has received over 400 comments on the proposal, most of which express opposition to the proposed revisions. Mr. Keller predicted that none of the revisions will be adopted in the form proposed.

The panel also discussed the SEC's proposal on crowdfunding.[5] Annemarie Tierney, Executive Vice President—Legal, General Counsel and Corporate Secretary of SecondMarket, Inc., indicated that while crowdfunding is an appealing idea, the structure imposed on it by Congress and the SEC may make it unworkable. Another panelist noted that there is a negative perception of crowdfunding in the venture capital community due to its potential to significantly increase the number and diversity of shareholders in companies that use crowdfunding.

The panel then covered the SEC's proposed amendments to Regulation A, which were mandated by the JOBS Act (which the SEC and others referred to as Reg A+).[6] The proposal would build upon Regulation A, which is an existing exemption from registration for small offerings of securities up to $5 million within a 12-month period, and would enable companies to offer and sell up to $50 million of securities within a 12-month period. The panelists agreed that Reg A+ has the potential to be much more relevant than current Regulation A and that the ultimate utility of Reg A+ will depend, in large part, on whether the SEC will permit secondary trading of securities sold in Reg A+ offerings in the future.

The panelists then discussed the impact of the JOBS Act amendments to the Exchange Act Section 12(g) reporting thresholds. Mr. Beller noted that both for companies that plan to go public at some point in the future and for companies that plan to quasi-permanently stay out of the public reporting regime (so called "quasi-public" companies), planning is key to avoiding inadvertently triggering the reporting thresholds. He discussed (1) adding provisions to a company's charter and bylaws to permit the company to determine how many shareholders it has at any given point and whether those shareholders are accredited, and (2) building in enforcement mechanisms such as rights of first refusal and mandatory puts to stay below the thresholds.

SEC Disclosure Review and Rulemaking

Current and former senior SEC officials discussed various disclosure and rulemaking issues on several panels during the Institute. On one panel, Mark Kronforst, Associate Director and Chief Accountant at the Division of Corporation Finance, described key areas of SEC staff focus for reviews in 2014. He indicated that the staff is taking a close look at companies' use of metrics in their filings, noting that while the SEC rarely asks companies to take metrics out, it may ask companies to clarify their explanations and provide additional context for the metrics. He also explained that even though non-GAAP financial measures are not the highest priority for the SEC staff right now, comments are still issued when warranted, such as when the adjustments used are not labeled clearly (a current focus) or when the GAAP figure is not given equal prominence (a focus last year). Mr. Kronforst also explained that the SEC is paying close attention to the headlines regarding cybersecurity breaches and comparing any incidents to companies' disclosures to make sure companies are complying with the Division of Corporation Finance's 2011 cybersecurity guidance.[7]

Meredith B. Cross, former Director of the Division of Corporation Finance, discussed a number of key points to keep in mind when thinking about disclosure and social media. She pointed out that the SEC's recent report regarding whether the CEO of Netflix, Inc. violated Regulation FD by posting information on his personal Facebook account did not change any of the rules applicable to disclosure through social media.[8] The report simply clarified the existing rules set forth in the SEC's 2008 Guidance, which explains that for purposes of complying with Regulation FD, a company makes public disclosure when it distributes information "through a recognized channel of distribution."[9]

Ms. Cross pointed out that while there are no new compensation and governance disclosure rules coming into effect this proxy season, we are seeing companies revise and supplement their proxy disclosures based on pressure from large shareholders and proxy advisory firms.

The panel also addressed various areas of rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) that have not been enacted, including the disclosure requirements related to pay versus performance, hedging policies, clawback policies and internal pay ratios. Panelists noted that in some of these areas companies are getting ahead of the requirements by including related disclosures in their proxies. Companies generally have not taken this approach with the internal pay ratio disclosure, although some companies are working with their human resources and accounting departments to make sure that they will be able to gather the required information when a final rule is adopted.

The specialized disclosure requirements relating to resource extraction issuers, conflict minerals and Iran sanctions also were mentioned. In discussing the conflict minerals rules, which are currently on appeal before the U.S. Court of Appeals for the District of Columbia Circuit, Ms. Cross indicated that she does not think companies should wait for a court decision, but instead should do the work to comply in the event the rules are upheld.[10]

During a panel composed solely of officials from the Division of Corporation Finance, Mr. Higgins discussed where the SEC stands with respect to its required Dodd-Frank and JOBS Act rulemakings. He expects the internal pay ratio rules to be finalized in 2014, as well as the proposed changes to Regulation D and Form D. He discussed the difficulties the SEC has encountered with the crowdfunding rules (*e.g.*, the entirely new regulatory superstructure required for funding portals) and Reg A+ (*e.g.*, the controversial preemption of state law aspect of the rule). Mr. Higgins also indicated that although Dodd-Frank did not establish a timeline for the rulemakings dealing with pay versus performance, clawback policies and hedging policies, he expects these rules to be proposed in 2014.

During the Division of Corporation Finance panel, Mr. Ingram discussed notable developments in the shareholder proposal season and pointed out that this season has been more litigious than prior ones. He also mentioned the recently issued C&DIs regarding the unbundling of proxy proposals, which clarify that, in the context of charter amendments, the SEC ordinarily would not object to the bundling of any number of immaterial matters with a single material matter.[11] One particularly interesting aspect of the new guidance related to a company's obligation to unbundle a proposal if management "knows or has reason to believe" that a particular amendment included in the proposal is one on which shareholders could reasonably be expected to wish to express a view separate from their views on the other amendments in the proposal.[12] None of the panelists from the SEC provided clarification regarding this aspect of the guidance.

Continuing on a topic raised by Chair White, the Division of Corporation Finance panel discussed "disclosure overload" at length and what the SEC, companies, and practitioners can do to reduce the amount of information included in filings that is not helpful to investors. Mr. Kronforst cautioned against relying heavily on comments received by other companies to decide what information to disclose because not all comments are applicable to all companies, even within the same industry. One panelist indicated that simply because the SEC asks for information supplementally, does not mean it needs to be included in a company's disclosure on a going forward basis. Shelley E. Parratt, Deputy Director of the Division of Corporation Finance, stressed that a company should not blindly leave a disclosure in its filing simply because the SEC asked for it in a prior period.

Enforcement and Criminal Investigations

Robert S. Khuzami, former Director of the SEC's Division of Enforcement, hosted a panel that included Andrew Ceresney, Co-Director of the Division of Enforcement, and Lorin L. Reisner, Chief of the Criminal Division, U.S. Attorney's Office for the Southern District of New York. The panelists discussed the problems associated with the lack of coordination among the various enforcement agencies both domestically and internationally. Mr. Khuzami expressed his belief that everyone agrees that investigations are coordinated better than in the past, but that issues arise when multiple agencies levy their own separate sanctions based upon the same conduct. Mr. Ceresney indicated that the SEC does try to coordinate with the U.S. Attorney's Office in an effort to prevent "double-counting" settlements.

The panel also addressed U.S. District Judge Jed S. Rakoff's recent criticism of government enforcement entities for not prosecuting high-level executives in connection with the financial crisis. The panelists expressed their views on why more cases based on "willful blindness" or "conscious disregard" theories were not warranted. One panelist pointed out that such cases should be brought very carefully given the tendency to water down criminal intent requirements when the underlying behavior was merely negligent.

The panel also discussed deferred prosecution agreements (DPAs). Mr. Ceresney expressed his view that DPAs are an important remedy for the SEC to use to guard against future violations, but noted that DPAs should not be used to require broad changes to an entire industry. One panelist expressed concern about the lack of judicial oversight of DPAs, recognizing, however, that recently there has been increased judicial oversight of DPAs by agreement of both parties.

In a later panel, Mr. Ceresney identified the SEC's current enforcement priorities. Areas that remain a focus of SEC attention include investment adviser violations, insider trading, Foreign Corrupt Practices Act violations, and financial reporting and audit issues. He pointed out that the Division of Enforcement's new Financial Reporting and Audit Task Force has improved its ability to detect misconduct involving financial reporting and auditing. New areas of emphasis include compliance issues identified by the Office of Compliance Inspections and Examinations, market structure issues involving exchanges and alternative trading systems, microcap fraud, and compliance issues relating to the new rules regarding derivatives, general solicitation, and credit rating agencies.

Shareholder Activism and Corporate Governance

David A. Katz of Wachtell, Lipton, Rosen & Katz led a discussion of shareholder activism and corporate governance trends in 2013. He noted that some prominent activists have made significant money from their investments, which has attracted other less well-known funds to enter this area. Mr. Katz also pointed out that more traditional investors, such as mutual funds, are increasingly calling on activists to target underperforming companies within their portfolios to turn them around. He stressed that activists are not limiting themselves to targeting only small, underperforming companies, but are targeting large, profitable companies as well. Multiple panelists noted that we are increasingly seeing high-quality dissident board candidates being nominated by activists.

The panelists discussed increased company settlements with shareholder activists, which is typically the preferred outcome for both activists and companies. One panelist noted that activists are increasingly seeking more than just one board seat and they are approaching companies with specific plans for extensive business changes.

M&A Trends and Developments

Several panelists noted that while 2013 was a lackluster year in the M&A market generally, it was a relatively strong year for private equity, which accounted for approximately 30 percent of deal volume.

The panel discussed the continued scrutiny investment banking conflicts are receiving from judges and investors. One panelist noted that, while it is true that board members recognize that the inherent conflicts when investment bankers are paid on a contingent fee basis, board members have become increasingly interested in any personal conflicts investment bankers may have, such as ownership positions in relevant companies or prior work experience with relevant companies. The panel also discussed the increasing number of appraisal actions as hedge funds and other investors are engaging in "appraisal arbitrage" by buying shares that are going to be cashed out in a merger.

The panelists further discussed new Delaware General Corporation Law Section 251(h), which is intended to facilitate the use of friendly tender offers.[13] One panelist noted that the new section facilitates leveraged acquisitions by financial buyers by eliminating the potential delay between the offer and the merger closing, which gives financial buyers immediate access to collateral after the tender offer closes.

The panelists also discussed Delaware courts' treatment of non-reliance provisions in private company acquisition agreements, highlighting recent Delaware cases that address this topic.[14] Under Delaware law, a properly worded non-reliance clause can protect a seller from claims of fraud outside the contract. However, a mere "no other representations" provision or "entire agreement" provision that does not specifically state that the parties disclaim reliance upon extra-contractual statements will not preclude fraud claims.[15]

There also was discussion of Delaware's three-year statute of limitations for contract actions.[16] The panelists noted that claims based on representations in a contract generally cannot be brought after the three-year statute of limitations has passed, even if the contract specifically provides that the representations survive for a longer period. However, Delaware common law provides that the statute of limitations for a contract can be extended from three years to 20 years by making the contract "under seal," which simply involves including specific language to that effect in the contract.[17]

Notes

1. This data and a wide range of related analyses are presented on the SEC's website. Available at *http://www.sec.gov/marketstructure/midas.html*.

2. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules (Interpretation # 260.16) (December 4, 2013), available at *http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm*.

3. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules (Interpretation # 260.29) (January 3, 2014), available at *http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm*.

4. *See* SEC Release No. 33-9416, "Amendments to Regulation D, Form D and Rule 156 under the Securities Act," July 10, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9416.pdf*.

5. *See* SEC Release No. 33-9470, "Crowdfunding," October 23, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9470.pdf.*

6. *See* SEC Release No. 33-9470, "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," December 18, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9497.pdf.*

7. SEC Division of Corporation Finance Disclosure Guidance, Topic No. 2: Cybersecurity (October 13, 2011), available at *www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm*.

8. SEC Release No. 34-69279, "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings," April 2, 2013, available at *http://www.sec.gov/litigation/investreport/34-69279.pdf*.

9. SEC Release No. 34-58288 "Commission Guidance on the Use of Company Web Sites," August 7, 2008, available at *http://www.sec.gov/rules/interp/2008/34-58288.pdf.*

10. The court's decision is expected out before the first reports under the conflict minerals rules are required to be filed on June 2, 2014.

11. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Rule 14a-4(a)(3) (Interpretation # 101.01-#101.03) (January 24, 2014), available at *http://www.sec.gov/divisions/corpfin/guidance/14a-interps.htm*.

12. *Id.* at Interpretation #101.02.

13. The provision permits parties to opt in to a "medium form" merger following a tender or exchange offer and eliminate the previously required stockholder vote.

14. The following cases were discussed: *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1035 (Del. Ch. 2006) ("[T]he case law of this court gives effect to non-reliance provisions that disclaim reliance on extra-contractual representations"); *RAA Mgmt., LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107, 119 (Del. 2012) ("The non-reliance and waiver clauses in the NDA preclude the fraud claims asserted by [Buyer] against [Seller]"); *Anvil Holding Corp. v. Iron Acquisition Co.*, 2013 Del. Ch. LEXIS 129 (Del. Ch. May 17, 2013) (holding that the "no other representations" provision and "entire agreement" provision in an agreement "do not state that the parties disclaim reliance upon extra-contractual statements"); *Transdigm Inc. v. Alcoa Global Fasteners, Inc.*, 2013 Del. Ch. LEXIS 137 (Del. Ch. May 29, 2013) (holding that a seller's anti-reliance provisions did not "bar the buyer's claim for fraudulent concealment of material information").

15. *See Anvil Holding Corp.,* 2013 Del. Ch. LEXIS 129 at *27.

16. *See* Del. Code Ann. tit. 10 § 8106.

17. *See Whittington v. Dragon Group, L.L.C.,* 991 A.2d 1, 14 (Del. 2009).

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