INSIGHTS

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INSIDE THE SEC

Highlights from the San Diego Securities Regulation Institute

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The 42nd Annual Securities Regulation Institute (Institute), sponsored by Northwestern University School of Law, was held January 26th through January 28th, 2015, in Coronado, California. The panels at the Institute covered a number of topics, including shareholder activism, proxy season trends and developments, SEC enforcement and criminal investigations, and mergers and acquisitions developments. Speakers and panelists at the Institute included the Honorable Leo E. Strine Jr., Chief Justice of the Delaware Supreme Court, SEC Commissioner Daniel M. Gallagher, Jr., the former Chief Justice of the Delaware Supreme Court Myron T. Steele, senior Securities and Exchange Commission (SEC) staff, and practitioners.

Keynote Address

Chief Justice Strine's address focused on the U.S. Supreme Court's recent decision in *Burwell v. Hobby Lobby*[1] and the implications of that decision and other Supreme Court decisions, including *Citizens United v. FEC*,[2] for corporate law. Chief Justice Strine noted that the Supreme Court rarely addresses corporate issues, which are traditionally the province of state law, and its holdings in both *Citizens United* and *Hobby Lobby* seem to misinterpret the fundamental purpose of state corporate laws and thus threaten to disrupt how companies and the law operate in practice.

Chief Justice Strine pointed out that under the corporate law of Delaware and other states, the duty of the board of directors is to maximize profit for stockholders, within the constraints on their discretion set by external law and regulations. Corporate managers can make decisions on behalf of the corporation that benefit other constituencies, but only if they also have the purpose of promoting stockholder welfare. He argued that *Hobby Lobby* ignores certain basic aspects of corporate law, particularly the principle that a corporation is an entity legally distinct from its stockholders, and commented that

> Leaving social, political and religious issues to other bodies of law is hard to justify after these decisions, especially because individual investors are poorly positioned to constrain corporate managers in these areas. Because of that reality, those who

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advise corporate boards are likely to find themselves facing the fallout of this changing dynamic for years to come.

Shareholder Activism

David A. Katz of Wachtell, Lipton, Rosen & Katz led a discussion of shareholder activism. All panelists agreed that activism is here to stay. They highlighted current economic conditions—marked by low interest rates and high stock market values—and how this has fueled activist activity and noted the increased capacity and leverage that activists possess in today's environment, including through an estimated $220 billion of capital (a 24 percent increase over the past several years) and unreported derivative positions.

Sabastian V. Niles, counsel at Wachtell, Lipton, Rosen & Katz, reviewed the key tactics being employed by activists today, including the use of sophisticated derivative instruments that do not trigger Schedule 13D reporting, the use of both social and traditional media, and outreach efforts to large institutional investors and sell-side research analysts.

Michelle M. Anderson, Chief of the Office of Mergers and Acquisitions in the SEC Division of Corporation Finance, acknowledged that some of the Section 13(d) rules may require modernization, in part, due to the sophisticated tactics currently being used by activists. She noted that the SEC staff is continuing to explore ways to modernize the beneficial ownership rules, including an evaluation of whether the current 10-day period to file an initial report on Schedule 13D should be shortened, whether the definition of "beneficial ownership" under Rule 13d-(3) should be revised to include cash swaps and other derivative instruments, and whether the triggering events for amending Item 4 disclosure in a Schedule 13D filing should be revised. Ms. Anderson indicated, however, that while the staff is considering these issues, there is no active rulemaking initiative at this time. She did note that in an effort to improve the proxy voting process, the SEC would be hosting a roundtable in February to consider the use of universal proxy ballots in contested director elections.[3]

Overview of the Current Capital Markets

Gordon K. Davidson of Fenwick & West LLP led a panel discussion of the current state of the capital markets. Among other topics, the panelists discussed the use of metrics by companies preparing for an IPO. Such companies need to carefully consider what metrics to use, as the IPO is likely the first time a company will signal to the street how its business is run and how the company thinks it should be judged. Keith F. Higgins, Director of the Division of Corporation Finance, noted that the SEC staff frequently issues comments on metrics, asking registrants to clearly define the assumptions involved in calculating the metrics and to explain to shareholders the potential shortfalls of any metrics disclosed in their filings.

Mergers and Acquisitions: Trends and Developments

A panel comprised of various M&A professionals described 2014 as a banner year for M&A activity and noted that the current M&A market is not as heavily driven by large private-equity sponsored going-private deals as was witnessed over the past eight years. The panelists attributed this to more activity by large corporate buyers who, due to high stock prices generally, are able to use their stock as currency to offset high stock prices of target companies. The panelists also observed a recent decline in the number of club deals (deals in which several private equity firms participate in a buyout together).

The panelists noted that the Delaware Court of Chancery continues to criticize investment bankers for undisclosed conflicts of interest. This past year's significant case was *In re Rural Metro Corp. Stockholders Litigation*,[4] in which the seller's

financial advisor was found liable for substantial damages for having aided and abetted fiduciary duty breaches by the seller's board of directors. Chief Justice Strine explained that in many M&A transactions independent directors cannot rely on management due to management's inherent conflicts of interest so they need special advisors such as investment bankers. Because bankers are supposed to play a conflict-curing role, it is critical for them to disclose any conflicts of interest.

The panel concluded with a brief discussion on fee-shifting bylaws. Noting that proxy advisory firms and the SEC are just now becoming comfortable with forum selection clauses, Chief Justice Strine expressed the view that companies should first allow forum selection clauses to become established before rushing to adopt fee-shifting bylaws. He further noted that fee-shifting bylaw provisions are very difficult to draft well. In a subsequent panel, David R. Fredrickson, Associate Director and Chief Counsel of the Division of Corporation Finance explained that, through the comment process, the staff is requesting that issuers make clear in their registration statements whether their fee-shifting bylaw provisions are intended to cover federal securities laws claims, including those relating to the offering.

Updates from SEC Senior Staff

Current and former senior SEC officials discussed various disclosure and rulemaking issues on several panels during the Institute. Mr. Higgins addressed developing Division guidance on the use of social media. He explained that while Regulation G generally requires that any disclosure of a non-GAAP financial measure be accompanied by certain disclosures, including a reconciliation to the most comparable GAAP measure, the Division believes that where the non-GAAP financial measure is disclosed using an electronic communication platform that limits the number of characters (*e.g.*, Twitter), this requirement can be fulfilled by including a direct link to the required disclosure and reconciliation. Mr. Higgins also noted that if a character-limited electronic communication is sent containing only a link to an electronic road show, the communication would not need to be filed with the SEC and would not be subject to other requirements or restrictions.

The SEC staff also discussed the Division's recent guidance regarding Rule 304(e) of Regulation S-T, which states that "filers may not present in a graphic or image file information such as text or tables that users must be able to search and/or download into spreadsheet form." A recently published Compliance and Disclosure Interpretation explains that "a filer may present required information using graphics that are not text-searchable and still comply with Rule 304(e) if the filer also presents the same information as searchable text or in a searchable table within the filing."[5]

Michele Anderson discussed the recent issuance of a no-action letter permitting issuers (or their parents or wholly-owned subsidiaries) to conduct five-business day tender offers for any and all non-convertible debt securities, including non-investment grade debt securities, when certain conditions are met.[6] This no-action letter supersedes prior guidance and "lore" on abbreviated debt tender offers that has accumulated over the last 30 years. Ms. Anderson anticipates that her office will address through further guidance any issues that come up in offers that are not eligible for this type of relief, including issues relating to early settlements and periods when an "early tender" fee is payable.

Mr. Higgins discussed the evolving issue of waivers of "bad actor" disqualification under Rule 262 of Regulation A and Rules 505 and 506 of Regulation D. He noted that while the Commission has delegated authority to grant waivers of this kind to the Director of the Division of Corporation Finance, since 2014 a majority of the waivers have been granted through orders at the Commission level. Mr. Higgins explained that while waivers previously had either been granted

or denied absolutely, the Commission's recent waivers contain conditions and time limitations.[7]

Mr. Higgins explained that the Division continues to look at ways to modernize Regulation S-K and Regulation S-X. Mr. Higgins expects that one or more concept releases and possibly some proposed rules on this topic will be published during 2015. Mr. Higgins also announced that the staff is in the process of updating the guidance in Staff Legal Bulletin No. 4 to provide further instruction regarding spin-off transactions that need not be registered.

Key Trends and Developments of the 2015 Proxy Season

A panel led by Meredith Cross, former Director of the Division of Corporation Finance, discussed key trends and developments for the 2015 proxy season. Abe M. Friedman, Managing Partner of CamberView Partners LLC, noted that in the current environment clients are driving asset management firms to become more engaged with the issuers in which the asset managers invest. Mr. Friedman recommended that issuers engage with investors outside of the busy proxy season so that a relationship can be formed in advance and to avoid any surprises when the issuer's proxy statement comes out. Mr. Friedman suggested that management lead the shareholder engagement effort, with directors becoming involved only in certain situations.[8]

The panel also discussed SEC Chair Mary Jo White's recent direction to the SEC staff to review Rule 14a-8(i)(9) (the basis to exclude potentially conflicting proposals) and report back to the Commission on its review.[9] As a result of this directive, the Division of Corporation Finance announced that it will not express any views regarding the application of Rule 14a-8(i)(9) during the current proxy season.[10] The panelists noted that there is now substantial uncertainty as to what companies that were planning to exclude proposals on the basis of Rule 14a-8(i)(9) will do. Companies could choose to include their own proposal and simply exclude the purportedly conflicting shareholder proposal without receiving a specific letter from the SEC or could go to court and seek a declaratory judgment. Companies also may include both proposals in their proxy statements. The panelists noted that it remains to be seen whether the staff will comment on any of the issues raised in these situations when it reviews the affected companies' preliminary proxy statements.

The panelists agreed that proxy access is the most significant issue of this proxy season and will have a lasting impact on the public company governance landscape.

Getting Practical on Accounting and Auditing

A panel focused on accounting and auditing issues, discussed developments in revenue recognition, for which the Financial Accounting Standards Board (FASB) has issued a long-awaited, converged standard that also has been adopted by the International Accounting Standards Board (IASB). Effective for fiscal years beginning after December 15, 2016,[11] the new standard eliminates all industry-specific guidance, with certain topics (*e.g.*, financial instruments, leases, insurance) falling outside its scope. It will require the exercise of more judgment, greater use of estimates and more robust disclosures. As companies understand how application of the new standards affects their reported revenue, they may want to revisit terms of their contracts with customers. The panelists emphasized that the revenue recognition standard is not simply an accounting issue and will require involvement from all departments within the organization, noting that revenue recognition also may implicate income taxes, debt covenants and executive compensation.

The panel discussed three methods for correcting accounting errors: correcting in the current period as an "out of period" item, revising prior periods (so-called "little r" restatements), and restating prior periods (so-called "Big R"

restatements). The method to be employed generally depends on the materiality of the error.

Judicial and Legislative Developments

Joseph A. Grundfest of Stanford Law School led a panel discussion regarding recent judicial and legislative developments. Among other topics, the panel discussed *Halliburton Co. v. Erica P. John Fund, Inc. (Halliburton II)*[12] and the fraud on the market doctrine, the SEC's increased reliance on administrative proceedings in enforcement actions and, *In the Matter of Flannery and Hopkins*.[13] Regarding *Halliburton II*, the panelists noted that while the Supreme Court declined to overturn the 25 year-old decision in *Basic Inc. v. Levinson*,[14] which established the "fraud-on-the-market" presumption of reliance in Section 10(b) class actions, it also held that defendants can defeat the presumption at the class certification stage by introducing evidence that the alleged misrepresentation did not affect the stock price.

Enforcement and Criminal Investigations

Andrew Ceresney, Director of the SEC's Division of Enforcement and Anne K. Small, General Counsel of the SEC, discussed some of the key areas of focus of the Division of Enforcement over the past year. Mr. Ceresney noted that financial reporting and audit-related issues were a key area of focus for the staff, with a significant increase in enforcement actions, due in large part to the efforts and new tools utilized by the SEC's Financial Reporting and Audit Task Force, which was created in June 2013. Mr. Ceresney also noted that the public should expect the Division to remain focused on the pursuit of deficient internal controls (even in cases where there is no fraud), and we will likely see an uptick in cases linked to auditors, particularly with respect to auditor independence.

The panel also discussed and reviewed some of the key court decisions rendered in the past year, including the U.S. Court of Appeals for the Second Circuit's decision in *United States v. Newman*,[15] where the court concluded that a mere showing of friendship is insufficient to demonstrate a personal benefit sufficient to trigger a breach of a fiduciary duty by a tipper. Ms. Small noted the inconsistency of this decision with U.S. Supreme Court case law and other U.S. Circuit Court decisions and that the SEC recently filed a brief arguing for a rehearing of this case. Ms. Small also noted that notwithstanding this decision, the SEC intends to continue to bring insider trading cases predicated on personal benefits in the form of friendship and that the SEC has the benefit of bringing its cases in administrative court and in districts other that the Second Circuit where friendship has sufficed to establish the personal benefit element.

The panelists also discussed the fact that the SEC staff is increasingly asking for a waiver of the attorney-client privilege over substantive issues in investigations. Concerns were expressed about the chilling effect that such requests could have, but Mr. Ceresney articulated his view that if a party will be relying on advice of counsel as a defense, then the SEC should be able to see what the advice was.

Current Issues in Delaware General Corporation Law

Former Chief Justice of the Delaware Supreme Court Myron Steele hosted a panel on notable topics that recently have been presented in the Delaware courts. He began the panel by discussing the three levels of judicial review for director conduct (*i.e.*, business judgment deference, intermediate scrutiny, and entire fairness review) in the context of a sale of the company and highlighting a few notable cases that address this topic.[16] He stressed that the frequently referenced "Revlon duty" is, in fact, not a duty. According to Justice Steele, *Revlon* stands for the proposition that, if there is a change of control of the company or if the entity will not survive a transaction, the directors' fiduciary duty shifts from

being one owed to the corporate entity itself to being owed to the shareholders. He emphasized that there is no required or perfect plan; instead, directors are required to carefully devise a process that, given the circumstances, is designed to maximize the price obtained for shareholders.

Gregory Williams of Richards, Layton & Finger, PA, discussed going-private transactions and developments regarding the standard of review and burden of proof. He described the basic assumption that the onerous "entire fairness" standard applied if a controlling shareholder was taking a company private, but noted that, with the Delaware Supreme Court's 1994 decision in *Kahn v. Lynch Communication Systems, Inc.*,[17] the burden of proof could be shifted from the defendant to the plaintiff if the transaction was subject to the vote of a special committee of independent directors or subject to a "majority of the minority shareholder vote." He went on to explain that in *In re MFW Shareholders Litigation*,[18] the Delaware Chancery Court recently held that if both of those procedural protections were present, the standard would be lowered from entire fairness to the business judgment rule. Mr. Williams emphasized the importance of board minutes that reflect the board's thought process, as such minutes will inform the court better than any brief filed in litigation and will be helpful in preparing directors to testify. He also advised that resolutions creating and authorizing a special committee should be very clear about the broad powers being delegated to the committee, which should not be limited to considering and approving a specific transaction.

Patricia Vella of Morris, Nichols, Arsht & Tunnell LLP noted a recent trend of breach of fiduciary duty claims against directors for equity plan grants that violate the terms of equity plans—for example, when grants are made that exceed total shares authorized, exceeding specific caps authorized for a particular year, invalid waiver of terms and improperly authorized amendments. The practitioners on the panel noted the importance of reviewing equity plans and awards carefully and regularly, and acting to remediate any errors found.

Elena Norman of Young Conaway Stargatt & Taylor LLP discussed new Sections 204 and 205 of the Delaware General Corporation Law, which became effective April 1, 2014. Section 204 provides specific guidelines for ratifying defective corporate acts or transactions and stock that would otherwise be void or voidable, and Section 205 enables a judicial proceeding in the Delaware Court of Chancery to determine the validity of any corporate act and any stock or stock rights.

Notes

1. *Burwell v. Hobby Lobby*, 134 S. Ct. 2751 (2014) (holding that, as applied to closely held corporations, the Department of Health and Human Services regulations imposing the contraceptive mandate violate the Religious Freedom Restoration Act of 1993).

2. *Citizens United v. FEC*, 558 U.S. 310 (2010) (holding that a provision of the Bipartisan Campaign Reform Act prohibiting unions, corporations and not-for-profit organizations from broadcasting electioneering communications within 60 days of a general election or 30 days of a primary election violates the free speech clause of the First Amendment to the U.S. Constitution).

3. *See* "SEC to Hold Roundtable on Proxy Voting," available at *http://www.sec.gov/news/pressrelease/2015-15.html#.VMwTbL72elI*.

4. *In re Rural Metro Corp. Stockholders Litigation*, C.A. No. 6350-VCL (Del. Ch. Mar. 7, 2014).

5. *See* SEC Division of Corporation Finance, Compliance & Disclosure Interpretations, Regulation S-T (Interpretation #118.01) (Jan. 23, 2015), available at *http://www.sec.gov/divisions/corpfin/guidance/regs-tinterp.htm#118.01*.

6. SEC No-Action Letter, *Cahill Gordon & Reindel LLP* (Jan. 23, 2015).

7. *See, e.g.*, *Oppenheimer & Co. Inc.*, Release No 9712 (Jan. 23, 2015); *Bank of America, N.A.*, Release No. 9682 (Nov. 25, 2014).

8. For example, it would be appropriate to have the compensation committee chair involved in engagement efforts after a low say-on-pay vote or in anticipation of receiving a low vote. It also would be appropriate for the lead independent director to engage on issues such as independent chair shareholder proposals.

9. *See* "Statement from Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposals," available

at *http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html#.VM9usGjF-So*.

10. *Id*.

11. The new standards will be effective for fiscal years beginning after January 1, 2017, for companies following IASB standards.

12. *Halliburton Co. v. Erica P. John Fund, Inc.*,134 S. Ct. 2398 (2014).

13. *In the Matter of John P. Flannery and James D. Hopkins*, Release No. 33-9689, Securities Act of 1933, Securities and Exchange Commission, (Dec. 15, 2014).

14. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

15. *United States v. Newman*, Nos. 13-1837, 13-1917 (2d Cir. Dec. 10, 2014).

16. The cases discussed were *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009); and *C&J Energy Servs., Inc. v. City of Miami Gen. Employees' and Sanitation Employees' Ret. Trust*, No. 655/657, 2014 (Del. Dec. 19, 2014).

17. *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del., 1994), *aff'd Kahn* 669 A.2d 79 (Del. 1995).

18. *See In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. 2013), *aff'd*, *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).