INSIGHTS

The Corporate & Securities Law Advisor

VOLUME 35, NUMBER 2, FEBRUARY 2021

Virtual Annual Meetings Page 3

DOUGLAS K. CHIA of the Rutgers Center for Corporate Law and Governance provides a summary of best practices for virtual annual meetings based on the report of the 2020 Multi-Stakeholder Working Group on Practices for Virtual Shareholder Meetings.

SEC Financial Reporting and Disclosure Enforcement Actions Page 9

MARK SCHONFELD, TIMOTHY ZIMMERMAN, LAUREN MYERS, and **MARIE ZOGLO** of Gibson, Dunn & Crutcher LLP discuss SEC enforcement cases involving accounting, financial reporting and disclosure issues during the second half of 2020.

Whistleblower Action as Corrective Disclosure Page 17

GLENN K. VANZURA and **KEVIN C. KELLY** of Mayer Brown LLP examine a Ninth Circuit decision that may erode some of the protections in the Private Securities Litigation Reform Act due to allegations in a whistleblower lawsuit.

DEPARTMENTS

21 IN THE COURTS

Kodesh does not preclude industry bars...

25 CLIENT MEMOS

Valuable, practical advice...

29 INSIDE THE SEC

Highlights from the San Diego Securities Regulation Institute...

Wolters Kluwer

www.WoltersKluwerLR.com

INSIGHTS

The Corporate & Securities Law Advisor

Editor-in-Chief
AMY L. GOODMAN
(phone) 301-908-0938
agoodman16@verizon.net

EDITORIAL ADVISORY BOARD

DENNIS J. BLOCK
Greenberg Traurig, New York, NY

FAITH COLISH
Carter Ledyard & Milburn LLP, New York, NY

ARTHUR FLEISCHER JR.
Fried, Frank, Harris, Shriver & Jacobson, LLP,
New York, NY

JAMES C. FREUND
Skadden, Arps, Slate, Meagher & Flom, LLP,
New York, NY

EDWARD F. GREENE
Cleary Gottlieb Steen & Hamilton LLP,
New York, NY

KARL A. GROSKAUFMANIS
Fried, Frank, Harris, Shriver & Jacobson, LLP,
Washington, DC

JOHN J. HUBER
FTI Consulting, Inc., Washington, DC

STANLEY KELLER
Locke Lord LLP, Boston, MA

DONALD C. LANGEVOORT
Professor, Georgetown Law Center,
Washington, DC

JOHN M. LIFTIN
General Counsel
The D.E. Shaw Group, New York, NY

GARY G. LYNCH
Davis Polk & Wardwell LLP
New York, NY

BRUCE ALAN MANN
Morrison & Foerster, LLP, San Francisco, CA

JOHN F. OLSON
Gibson, Dunn & Crutcher LLP, Washington, DC

JEAN GLEASON STROMBERG
Washington, DC

HERBERT WANDER
KattenMuchinRosenman LLP, Chicago, IL

JOHN MARK ZEBERKIEWICZ
Richards, Layton & Finger, P.A., Wilmington, DE

EDITORIAL OFFICE
28 Liberty Street,
New York, NY 10005
212-771-0600

Wolters Kluwer
Richard Rubin, Publisher
James Orefice, Managing Editor

INSIGHTS (ISSN No. 0894-3524) is published monthly by Wolters Kluwer, 28 Liberty Street, New York, NY 10005. POSTMASTER: Send address changes to **INSIGHTS,** 7201 McKinney Circle, Frederick, MD 21704. To subscribe, call 1-800-638-8437. customer service, call 1-800-234-1660 or visit www.wolterskluwerlr.com.

For article reprints and reprint quotes contact *Wrights Media* at 1-877-652-5295 or go to *www.wrightsmedia.com.*

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other professional assistance is required, the services of a competent professional person should be sought.

—From a *Declaration of Principles* jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.

www.WoltersKluwerLR.com

CORPORATE GOVERNANCE

Practices for Virtual Shareholder Meetings

With the growth of virtual annual meetings in 2020, a number of practices are developing that will likely be viewed as standard going forward. A multi-stakeholder working group has issued a report that provides specific, practical guidance on how to conduct a virtual annual meeting.

By Douglas K. Chia

There were numerous virtual shareholder meeting (VSM) practices during the 2020 proxy season that shareholders will likely expect companies to treat as standard going forward, absent difficult circumstances. There were other practices that appeared to be evolving in ways that indicate they will likely become standard in the relatively near term, especially as VSM technology continues to improve and become more affordable for companies of all sizes. The following combines these practices to provide specific, practical, and usable guidance on how to conduct a VSM, understanding that not all companies will be able to adopt all of these practices at once. In this sense, this set of practices taken as a whole can be seen as aspirational for now.

Douglas Chia *is a Fellow at the Rutgers Center for Corporate Law and Governance. This article is based on the Report of the 2020 Multi-Stakeholder Working Group on Practices for Virtual Shareholder Meetings, which was released on December 10, 2020. Amy Borrus, Executive Director of the Council of Institutional Investors, and Darla C. Stuckey, President and CEO of the Society for Corporate Governance, co-chaired the Working Group, and it was facilitated by Douglas K. Chia.*

Disclosure

Instructions on How Shareholders Can Attend and Participate

Companies have a responsibility to provide clear and comprehensive instructions in proxy statements and related disclosure on how their shareholders can participate in their shareholder meetings. Therefore, it is incumbent on the company holding a VSM to:

- Provide shareholders with complete, detailed instructions on how they can attend the meeting and vote prior to and at the meeting.
- Write these instructions in "plain English" with the individual retail shareholder in mind.
- Place these instructions in a prominent and easily located place in the proxy statement for the meeting.
- Clearly distinguish and explain the different procedures for shareholders of record and shareholders holding shares in "street name" (*i.e.*, beneficial holders), if applicable.
- Highlight whether and why a shareholder must obtain and/or provide additional information (*e.g.*, separate control number, legal proxy) in advance of the meeting and how to do so.
- Indicate whether attendance is limited to shareholders or open to both shareholders and guests.

Instruction on How Shareholders Can Submit Questions

Shareholders expect to be able to ask questions at shareholder meetings, and companies have long included time for questions from shareholders at their annual meetings. Prior to their VSMs, companies should:

- Provide instructions on how and when shareholders will be able to ask questions at the meeting.

© 2021 CCH Incorporated and its affiliates. All rights reserved.

- Make it clear that a shareholder must attend as a verified shareholder (*i.e.*, not as a guest) to be eligible to ask questions (and vote) at the meeting.
- Explain any requirements or limitations on asking questions at the meeting (*e.g.*, time allotted for the Q&A session, time allotted per question, number of questions allowed for each shareholder, self-identification) and how the company may use discretion when selecting questions to answer and paraphrase questions for greater clarity.
- Explain whether and how the company will respond to any questions after the meeting that it was not able to answer at the meeting.
- If the company chooses to solicit questions in advance, provide instructions on how shareholders can ask questions in advance of the meeting.

Reasons for Using a Virtual-Only Format

As VSMs have not been the norm and have been used very infrequently before the COVID-19 pandemic, shareholders should receive an explanation of why the company has chosen this format for the particular meeting. Companies using a VSM format should explain in the proxy materials why the company has elected to hold the meeting using a VSM format instead of in-person.

Preparation

Company Training and Rehearsals

As with all planned events, it is important for those directly involved with the VSM to execute their duties, know what to expect, and anticipate and work out as many potential technical and communications difficulties as possible well in advance. To that end, the company should:

- Ensure adequate training on the VSM platform for any board members, company representatives, and contractors who will be actively working on or participating in the meeting.
- Ensure technical support staff is present during the meeting in case technical challenges arise.
- Rehearse the entire meeting with the individuals who will be actively working on the meeting.
- Ensure the adequacy and functionality of all means for the individuals who will be actively working on the meeting to communicate with each other during the meeting.

Communication with Shareholder Proponents

It is important that shareholder proponents be given access to the VSM for them to formally present their proposals, be heard clearly and uninterrupted by all attendees, and be fully able to participate in any Q&A session. To that end, companies should:

- Coordinate with proponents in advance of the meeting to discuss the logistics of presenting their proposals and subsequently asking questions.
- Provide proponents with a dedicated phone or video connection to present their proposals in real time at the meeting. (Test the connection on both sides in advance for any background noise, lags, or glitches.)
- Give proponents the option to provide a prerecorded statement that the company will play, or a written statement for management to read aloud, at the meeting in lieu of virtual attendance.
- Ensure proponents are aware of the meeting agenda, when their proposals will be introduced, how they will know when to speak, any time or length limitation for their statements, and other instructions needed for proponents to present.
- Discuss contingency plans in the event the proponent faces technical difficulties attending the meeting (such as providing a pre-recorded or written statement to the company as a backup).
- It also is important, and in their best interest, for shareholder proponents to make themselves available and be cooperative with advance preparation requests.

Allowing Shareholders to Test Internet Connectivity

As with any webcast or virtual meeting, there may be instances where attendees are not able to access the event easily due to inadequate technical capabilities that could have been resolved had they been tested in advance. To that end, companies should:

- Provide a simple way for attendees to check the online system compatibility requirements (*e.g.*, operating system, web browser, and Internet connection strength) to connect to the VSM and minimize the likelihood of connection issues well in advance of the meeting.
- Allow attendees to login at least 15 minutes before the scheduled start time to resolve connection issues.

VSM Platform

Audio or Video Format

Most VSMs thus far have been audio-only, where the meeting chair and other company participants and shareholder proponents can be heard, but not seen, by attendees. A number of companies have been conducting their VSMs with both audio and video, where the meeting chair and company participants are shown live and in real time from a studio or meeting room, replicating how an in-person meeting would look. However, in 2020, the COVID-19 pandemic caused most of these companies to also conduct their VSMs using only audio.

The hope of investors in the 2020 Working Group is that an increasing number of VSMs will use video (absent pandemic-like restrictions). The companies' view is that video can be considered only as production costs and risks of complications decrease, production standards change, and VSM platforms enable multiple people to appear on the platform by video from different locations. To maximize the effectiveness of remote communication, companies should weigh the costs and benefits of using video versus audio-only technology for the VSM with the aspiration to use video in some capacity.

Voting

Voting is a shareholder's most important and powerful right. To that end, companies must:

- Provide a prominently visible and simple mechanism on the main VSM page for shareholders to vote their shares (and change their votes if desired) during the time the polls are open.
- Confirm that the VSM service provider is able to maintain the integrity of, and the inspector of election is able to certify, the votes cast at the meeting.

Questions

For VSMs, the process for submitting questions is very different from in-person meetings. VSM platforms usually provide a space for shareholders to type and submit questions during the meeting, and the company will collect those questions and then read and address them during the Q&A session (as time permits). To replicate as closely as possible what an in-person Q&A session accomplishes, companies should:

- Provide a prominently visible and simple mechanism on the main VSM page for shareholders to submit questions to the company throughout the meeting.
- Clearly instruct shareholders that when submitting questions, they must identify themselves and provide contact information in case the company needs to address their question after the meeting.
- Request that the VSM service provider make all questions visible to the company verbatim and in real time.
- Request that the VSM service provider authenticate the identity of the shareholder asking the question.

Posted Content

It is essential that shareholders have all material information needed to make a voting decision. Also, most states require companies to make the list of shareholders of record entitled to vote available to

© 2021 CCH Incorporated and its affiliates. All rights reserved.

shareholders of record at the meeting for inspection during the meeting. Accordingly, companies should:

- Post complete and downloadable copies of the meeting agenda, rules of order, and all proxy materials for the meeting in a prominent location on the main VSM page.
- Provide a clear way for registered shareholders in attendance to be able to examine the list of registered shareholders entitled to vote, if required by and in accordance with the laws of the company's jurisdiction of incorporation.

Assistance for Attendees

As with any webcast or virtual meeting, there may be instances where attendees will face technical difficulties and seek immediate assistance during the meeting. Companies using a VSM platform should:

- Provide information in advance of the meeting (*e.g.*, in the proxy statement) for how shareholders can contact the company or the VSM service provider with questions about attending the meeting.
- Provide a visible mechanism on each page of the VSM platform for attendees to contact a live operator for assistance via phone, online "chat" function, or other form of real-time communication.

Proceedings of the Meeting

The formal legal portion of a VSM should be conducted in the same manner as any in-person shareholder meeting, with certain modifications or enhancements described below to make the virtual experience for the shareholder as close as possible to an in-person shareholder meeting.

Announcements

At any large meeting, it is important to provide clear guidance on how the meeting will be conducted and instructions for how to participate. In addition to the announcements traditionally or required to be made at annual meetings,[1] companies should announce immediately after the meeting is called to order:

- Instructions on how to vote during the meeting through the VSM site;
- Availability of proxy materials on the VSM site;
- Instructions on how and when to submit questions during the meeting and how and when they will be answered (including the need for questioners to provide their name and contact information); and
- Information for attendees requiring technical or other assistance.

Shareholder Proposals

Filing shareholder proposals is an important way for shareholders to express their concerns to the board and to other shareholders. To ensure that shareholder proponents are able to present their proposals properly at shareholder meetings, companies should:

- Encourage the proponent to connect to the meeting through a dedicated line before the meeting begins.
- Be clear in instructing the proponent when to begin his/her remarks, how much time is allotted to him/her and what will happen when the allotted time is over.
- Ensure that the proponent can clearly hear the chair and be heard by the attendees throughout his/her remarks (to the extent it is within the company's control).
- Ensure that any pre-recorded or written remarks provided by the proponent in lieu of attendance are made audible with the same sound quality as the rest of the meeting (to the extent it is within the company's control).

In addition, it is important that shareholder proponents adhere to the rules of order for the meeting and interact with company representatives in a cooperative and constructive manner. As most companies have not conducted many VSMs, proponents should be patient and flexible if legitimate technical issues arise.

Q&A Session

For many shareholders, a company's annual meeting is the only opportunity they will have to address questions and comments to the company's board of directors and shareholders, directly and in front of all of the company's shareholders in attendance. To this end, companies should:

- Allocate ample time on the agenda for Q&A based on the number of questions submitted in advance and reasonably anticipated to be received during the meeting.
- Explain how much time will be dedicated to the Q&A session and how the company will handle questions it may not be able to get to before time expires.
- Explain in what order the company will be reciting and answering the questions submitted.
- Note whether the company will take multiple questions from a single shareholder, and if so, in what order.
- Identify each questioner before reciting his/her question.
- Recite, to the best of its ability, each question verbatim as submitted by the shareholder, rewording or paraphrasing the shareholder's submission only when necessary to make it comprehensible.
- If answering once for multiple questions on the same topic, indicate that other shareholders submitted the same or a substantially similar question.
- Have members of the executive team and board committee chairs, in addition to the board chair (or lead director) and CEO, in attendance with the ability to audibly answer questions during the Q&A session as appropriate.
- Address all, or substantially, all questions received in advance of the meeting (if the company elects to solicit questions in advance).

In addition, shareholders asking questions should comport themselves with due respect for the meeting and other shareholders wishing to ask questions. In that regard, shareholders posing questions should:

- Follow the rules of order for the meeting and refrain from disruptive behavior, verbal abuse, and personal attacks unrelated to the company or board members, executives or other employees, or other shareholders.
- Keep questions and comments germane to the company and not raise personal grievances.

After the Meeting

After the meeting (within a reasonable period of time), the company should post on its website a recording of the entire meeting (including the Q&A session) for public viewing for a specified, extended period of time.

Optional and Emerging Practices

In addition to the standard and evolving practices described above, it is worth noting certain other practices that some companies used to enhance their VSMs. Companies should be encouraged to experiment with innovative practices and different types of digital communication to enhance the VSM experience for their shareholders.

- Posting all VSM instructions and related content, including what can be found in the proxy materials, on the company's website at the same time or promptly after the company files the definitive proxy materials with the Securities and Exchange Commission (SEC).
- Posting all questions received both before and during the meeting, and corresponding answers, on the company's website within a reasonable period of time after the meeting.
- Posting a transcript of the full meeting (including the Q&A session) on the company's website within a reasonable period of time after the meeting.
- Providing a live video feed of members of management and the board.
- Allowing shareholders to call in to ask questions and be heard in real time.
- Extending the time of the meeting to answer questions submitted.

© 2021 CCH Incorporated and its affiliates. All rights reserved.

- Providing closed captioning or signing for the hearing impaired.
- Providing real-time translations into multiple languages.
- Giving shareholders the ability to see all appropriate questions submitted in advance of the meeting and in real time and track prioritization of the questions in the queue throughout the meeting.
- Giving shareholders the ability to indicate their level of interest in particular questions shown in the queue.
- Allowing shareholder proponents and questioners to appear on video.

Note

1. These would include, but not be limited to, meeting agenda, timing of the opening and closing of the polls, names of the director nominees in attendance (and reasons for any absences), whether representatives of the company's independent auditors and inspector of election are in attendance, and quorum.

SECURITIES ENFORCEMENT

SEC in Transition: Enforcement Actions on Public Company Accounting, Financial Reporting and Disclosure in the Latter Half of 2020

While the SEC awaits a new Chairman, during the second half of 2020 it brought a number of significant enforcement cases involving financial reporting and disclosure issues. Several of these cases demonstrate the SEC's increased effort to identify potential misconduct proactively.

By Mark Schonfeld, Timothy Zimmerman, Lauren Myers, and Marie Zoglo

Unquestionably, 2020 was a year of challenges for the Securities and Exchange Commission's (SEC) Enforcement Division due to the COVID-19 pandemic. Nevertheless, after overcoming the initial hurdles of conducting investigations remotely, the Enforcement Staff continued to pursue investigations and bring enforcement actions.

Notwithstanding the challenges of the pandemic, the SEC brought a number of significant enforcement actions in the latter half of 2020 involving public company financial reporting and disclosure issues. Those cases included a range of actions concerning earnings management, revenue recognition, impairments, internal controls, and disclosures concerning financial performance. Looking back at the entirety of FY 2020, the SEC instituted 61 enforcement actions involving public company accounting and financial reporting.

More important than the numbers, however, several notable cases demonstrate the SEC's increased efforts to identify potential misconduct proactively, as well as to respond quickly to perceived issues resulting from the pandemic. Of particular note, and discussed in more detail below, three cases were the result of the Enforcement Division's "EPS Initiative," in which the Staff used risk-based data analytics to identify potential earnings management practices. Other significant cases resulted from the Enforcement Division's focus on cases related to the pandemic, including the first enforcement action based on disclosures concerning a company's continuing ability to operate sustainably despite the pandemic. Finally, a number of cases reflected the SEC's willingness to bring enforcement actions based on internal controls violations, even in the absence of other reporting or recordkeeping violations.

As 2020 drew to a close, SEC Chairman Jay Clayton, as well as the Co-Directors of the SEC's Enforcement Division, stepped down. The Biden administration has nominated Gary Gensler to be the new Chairman. Mr. Gensler was Chairman of the Commodity Futures Trading Commission (CFTC) in the Obama administration and presided over a period of heightened financial regulation and aggressive enforcement against major financial institutions. His experience, both at the helm of the CFTC and since, confirm expectations for increased regulation and enforcement. At the CFTC, Mr. Gensler oversaw the implementation of an entirely new regime for the regulation of the markets for derivatives, as well as the adoption of numerous regulations pursuant to the Dodd-Frank Act. The CFTC under his leadership also took aggressive enforcement actions against financial institutions in connection with the alleged manipulation of London Inter-bank Offered Rate (LIBOR). *The*

Mark Schonfeld, Timothy Zimmerman, Lauren Myers, *and* **Marie Zoglo** *are attorneys at Gibson, Dunn & Crutcher LLP.*

© 2021 CCH Incorporated and its affiliates. All rights reserved.

Wall Street Journal predicts that Mr. Gensler could give Wall Street its "most aggressive regulator in two decades."[1] In addition to a new Chairman, 2021 will also bring new senior leadership to the SEC's Division of Enforcement, as the Division's Co-Directors have left the agency as well.

Looking ahead, there is little doubt that the new administration will bring a heightened level of enforcement activity. But more important, we can expect a shift in focus and priorities away from retail investors and securities offering frauds and an increased emphasis on the financial reporting and disclosure practices of public companies and their auditors, as well as institutional market participants such as investment advisers and broker-dealers.

Financial Reporting Cases

EPS Initiative

In September, the SEC announced the Enforcement Division's "Earnings Per Share (EPS) Initiative" and the settlement of its first two investigations arising from the Initiative. According to the press release announcing the settled actions, the SEC described the EPS Initiative as using "risk-based data analytics to uncover potential accounting and disclosure violations."[2] Based on the facts described in the two settled actions, the EPS Initiative is focused at least in part on detecting a practice known as "EPS smoothing," *i.e.*, questionable accounting to achieve EPS results consistent with consensus analyst estimates. According to the SEC, the first company, a carpet manufacturer, made unsupported and non-GAAP-compliant manual accounting adjustments to multiple quarters in order to avoid EPS results falling below consensus estimates. The second company, a financial services company, used a valuation method that was inconsistent with the valuation methodology described in its filings, in order to appear to have consistent earnings over time. Without admitting or denying wrongdoing, the carpet manufacturer agreed to pay a $5 million penalty to settle the charges; the financial services company agreed to pay a $1.5 million penalty.

Based on our experience representing clients in such matters, the SEC's attention can be drawn simply by consistent EPS performance, even in the absence of any basis to suspect misconduct. In such circumstances, it is important to demonstrate to the Staff the integrity of accounting and financial reporting controls that negate the potential for improper accounting.

Other Financial Reporting Actions

In August, the SEC instituted a settled action against a motor vehicle parts manufacturer for failing to estimate and report over $700 million in future asbestos liabilities.[3] The SEC alleged that, from 2012 to 2016, the company failed to perform quantitative analyses to estimate its future asbestos claim liabilities, despite having decades of raw historical claims data. Instead, the company incorrectly concluded that it could not estimate these liabilities and therefore did not properly account for them in its financial statements. The company agreed to pay a penalty of $950,000 to settle the action, without admitting or denying the SEC's allegations.

> *The SEC's attention can be drawn simply by consistent EPS performance, even in the absence of any basis to suspect misconduct.*

Also in August, the SEC announced a settled action against a computer server producer and its former Chief Financial Officer (CFO) related to alleged violations of the antifraud, reporting, books and records, and internal accounting controls provisions of the federal securities laws.[4] According to the SEC's order, among other violations, the company incentivized employees to maximize revenue at the end of each quarter without implementing and maintaining sufficient internal accounting controls, resulting in a variety of accounting violations related

to prematurely recognized revenue. Without admitting or denying wrongdoing, the company agreed to pay a $17.5 million penalty; the CFO agreed to pay more than $300,000 as disgorgement and prejudgment interest and $50,000 as a penalty. Additionally, the company's CEO, who was not charged with misconduct, consented to reimburse the company $2.1 million in stock profits he received during the period when the accounting errors occurred under the Sarbanes-Oxley Act's clawback provision.

In September, the SEC instituted a settled action against an engine manufacturer that allegedly inflated its revenue by nearly $25 million by recording its revenues in a manner inconsistent with GAAP.[5] The SEC alleged that the company overstated its revenue by improperly recognizing revenue from incomplete sales, from products that customers had not agreed to accept, and from products with falsely inflated prices, among other violations of GAAP. Without admitting or denying the allegations, the company agreed to pay a $1.7 million penalty, and to undertake measures aimed at remediating alleged deficiencies in its financial reporting internal controls.

Also, in September, the SEC announced a settled action against a lighting manufacturer and four of its current and former executives for allegedly inflating the company's revenue from late 2014 to mid-2018, by prematurely recognizing revenue.[6] According to the complaint, using a variety of improper practices, the company recognized sales revenue earlier than allowed by GAAP and by the company's own internal accounting policies. The company also allegedly provided backdated sales documents to the company's auditor in order to cover up the improper practices related to premature revenue recognition. Without admitting or denying wrongdoing, the company agreed to pay a $1.25 million penalty, and the executives agreed to pay penalties as well.

The same month, the SEC also instituted a settled action against an automaker and two of its subsidiaries related to charges that the automaker disclosed false and misleading information related to overstated retail sales reports.[7] According to the SEC, the automaker inflated its reported retail sales using a reserve of previously unreported retail sales to meet internal monthly sales targets, regardless of the date of the actual sales. The company also allegedly paid dealers to falsely designate unsold vehicles as demonstrators or loaners so that the vehicles could be counted as having been sold, even though they had not been sold. The company and its subsidiaries agreed to pay a joint penalty of $18 million without admitting or denying the SEC's allegations.

Again, in September, the SEC instituted settled actions against a heavy equipment manufacturer and three of its former executives for allegedly misleading the company's outside auditor about nonexistent inventory in order to overstate its income.[8] According to the SEC, the company improperly accounted for nonexistent inventory and created false inventory documents, which it later provided to its outside auditor. The company allegedly deceived its outside auditor about approximately $12 million in revenue that it improperly recognized. Without admitting or denying the SEC's allegations, the company and its executives agreed to pay a total of $485,000 in penalties.

The company improperly accounted for nonexistent inventory and created false inventory documents.

In October, the SEC filed a complaint against a seismic data company and four of its former executives for accounting fraud for concealing theft by the executives, and for falsely inflating the company's revenue.[9] According to the complaint, the company improperly recorded revenue from sales to a purportedly unrelated client (that was actually controlled by the executives), with the company recording roughly $100 million in revenue from sales that it knew the client would be unable to actually pay. The US Attorney's Office for the Southern District

© 2021 CCH Incorporated and its affiliates. All rights reserved.

of New York also brought a criminal action against the company's CEO.

In November, in a case related to previously settled charges against a large bank, the SEC filed a complaint against the bank's former Senior Executive Vice President of Community Banking alleging that disclosures concerning the bank's "cross-sell" metric were misleading and that the defendant knew or should have known was improperly inflated.[10] The SEC also instituted a settled action against the bank's former chairman and CEO for certifying statements that he should have known were misleading arising from the bank's inflated cross-sell metric. The SEC alleged that the executives knew or should have known that the cross-sell metric was "inflated by accounts and services that were unused, unneeded, or unauthorized." The litigation against the vice president remains pending; the CEO agreed to pay a $2.5 million penalty to settle the charges, without admitting or denying the SEC's allegations.

In December, the SEC instituted a settled action against a China-based coffee company, alleging that the company defrauded investors by misstating its revenue, expenses, and net operating losses.[11] According to the complaint, among other things, the company recorded approximately $311 million in false retail sales transactions, as well as roughly $196 million in inflated expenses to conceal the fraudulent sales. The company agreed to pay a $180 million penalty to settle the action, without admitting or denying the SEC's allegations.

Disclosure Cases

Disclosures Related to the COVID-19 Pandemic

In March 2020, the SEC's Division of Enforcement formed a Coronavirus Steering Committee to oversee the Division's efforts to actively look for COVID-19 related misconduct. Since the Steering Committee's formation, there have been at least five enforcement actions for alleged disclosure violations related to COVID-19. There was an initial flurry of disclosure-related enforcement actions at the onset of the pandemic. These actions tended to involve microcap companies whose stock was suspended from trading after sky rocketing on the back of allegedly false statements about these companies' ability to distribute or access highly coveted protective equipment or technology that could detect or prevent the coronavirus.[12]

In the second half of 2020, the SEC has continued to bring enforcement actions against companies for allegedly making false statements about their ability to detect COVID-19. For example, in September, the SEC filed an action against a President and Chief Science Officer (CSO) alleging he issued false and misleading statements about the company's development of a COVID-19 blood test.[13] According to the complaint, the President and CSO incorrectly stated that (1) the company had purchased materials to make a test, (2) the company had submitted the test for emergency approval, and (3) there was a high demand for the test. The SEC's complaint also alleged that the defendant failed to provide necessary documents and financial information to the company's independent auditor to update the company's delinquent financial statements for 2014 and 2015.

More recently, the SEC announced charges against a biotech company and its CEO for making false and misleading claims in press releases that the company had developed a technology that could accurately detect COVID-19 through a blood test.[14] According to the complaint, the company and CEO made false and misleading statements about the existence of the physical testing device and the status of the Food and Drug Administration (FDA) emergency use authorization while advisors warned that the testing kit would not work as the company publicly described.

The SEC also is starting to bring enforcement actions against companies for alleged misstatements concerning how their financials were affected by the coronavirus. For example, in December, the SEC announced a settled order against a publicly traded restaurant company for allegedly incomplete disclosures in a Form 8-K about the financial effects of the pandemic on the company's business operations

and financial condition.[15] In brief, according to the SEC's settled order, the company disclosed that it expected to be able to operate "sustainably, " but did not disclose that it was losing $6 million in cash per week, it only had 16 weeks of cash remaining, it was excluding expenses attributable to corporate operations from its claim of sustainability, and it was not going to pay rent in April 2020. Without admitting or denying the SEC's findings, the company agreed to pay a $125,000 penalty and to cease-and-desist from further violations of the reporting provisions in Section 13(a) of the Securities Exchange Act of 1934 (Exchange Act) and Rules 13a-11 and 12b-20.

Other Disclosure Cases

In December, the SEC instituted a settled action against a US based multinational company for allegedly failing to disclose material information about the company's power and insurance businesses in three separate situations.[16] First, according to the SEC, the company misled investors by disclosing its power business's increased profits without also disclosing that between one-quarter and one-half of those profits were a result of reductions in the company's prior cost estimates. Second, the company failed to disclose that its reported increase in cash collections came at the expense of future years' cash and was derived principally from internal sales between the company's own business units. Third, the company lowered projected costs for its future insurance liabilities without disclosing uncertainties about those projected costs due to a general trend of rising long-term health insurance claim costs. Without admitting or denying wrongdoing, the company agreed to settle the allegations and pay a $200 million penalty. The settlement also contained a relatively unique undertaking by which the company agreed to self-report to the SEC regarding certain accounting and disclosure controls for one year.

Also, in September, the SEC announced a settled action against an automaker for allegedly misleading disclosures about its vehicles' emissions control systems.[17] According to the SEC, the automaker stated in a February press release and annual report that an internal audit had confirmed its vehicles complied with emissions regulations, without disclosing that the internal audit had a narrow scope and was not a comprehensive review, and also without disclosing that the Environmental Protection Agency and California Air Resource Board had expressed concerns to the automaker about some of its vehicles' emissions. The automaker agreed to pay a $9.5 million penalty without admitting or denying the SEC's allegations.

In September, the SEC instituted a settled action against a hospitality company for failing to fully disclose executive perks by omitting disclosure of approximately $1.7 million in executive travel benefits.[18] The benefits at issue related to company executives' stays at the company's hotels, and to the CEO's personal use of corporate aircraft from the period 2015 to 2018. The company agreed to pay a $600,000 penalty to settle the action, without admitting or denying the SEC's allegations.

Cases Involving Both Misleading Disclosures and Financial Reporting

In July, the SEC announced a settled action against a pharmaceutical company and three of its former executives for misleading disclosures and accounting violations.[19] According to the SEC, the company made misleading disclosures related to its sales to a pharmacy that the company helped establish and subsidize. For example, the company announced it was experiencing double-digit same store organic growth (a non-GAAP financial measure) without disclosing that much of that growth came from sales to the subsidized pharmacy and without disclosing risks related to that pharmacy. The SEC also alleged that the company improperly recognized revenue by incorrectly allocating $110 million in revenue attributable solely to one product to over 100 unrelated products. Without admitting or denying the allegations, the company agreed to pay a $45 million penalty; the former executives agreed to pay penalties ranging from $75,000 to $250,000 and to

© 2021 CCH Incorporated and its affiliates. All rights reserved.

reimburse the company for previously paid incentive compensation in amounts ranging from $110,000 to $450,000. Additionally, the Controller agreed to a one-year accounting practice bar before the SEC.

In August, the SEC instituted a settled action against the former CEO and Chairman of a car rental company alleging that he aided and abetted the company in filing misleading disclosures and inaccurate financial reporting.[20] According to the SEC, the former CEO lowered the company's depreciation expenses by lengthening the period for which the company planned to hold rental cars in its fleet, from holding periods of 20 months to holding periods of 24 and 30 months. The CEO did not fully disclose the new, lengthened holding periods, and did not disclose the risks associated with an older fleet. The complaint also alleged that, when the company fell short of forecasts, the former CEO pressured employees to "find money," mainly by reanalyzing reserve accounts, resulting in his subordinates making accounting changes that left the company's financial reports inaccurate. Without admitting or denying the SEC's allegations, the former CEO agreed to pay a $200,000 penalty and reimburse the company $1.9 million. The car rental company already had agreed to pay a $16 million penalty to settle related charges, in December 2018.

In September, the SEC announced a settled action against a charter school operator engaged in a $7.6 million municipal bond offering, and its former president alleging that the defendants provided inaccurate financial projections and failed to disclose the school's financial troubles.[21] According to the complaint, the school's offering document included inaccurate profit and expense projections that indicated the school would become profitable in the next year when, according to the SEC, the school knew or should have known that these projections were inaccurate. The complaint also alleged that the school failed to disclose that it was operating at a sizable loss and had made repeated unauthorized withdrawals from its reserve accounts to pay its debts and routine expenses. Without admitting or denying wrongdoing, the school and its former president agreed to a settlement enjoining them from future violations; the former president also agreed to be enjoined from participating in future municipal securities offerings and to pay a $30,000 penalty.

Also in September, the SEC instituted a settled action against a technology company for inflating reported sales by prematurely recognizing sales expected to occur later and for failing to disclose these practices.[22] According to the SEC's order, the company allegedly failed to disclose a practice used to increase monthly sales in which some regional managers would accelerate, or "pull-in," to an earlier quarter's sales that they expected to occur in later quarters. The company also allegedly failed to disclose that some regional managers sold to resellers known to violate company policy by selling product outside their designated territories in order to increase monthly sales. Finally, the SEC's order alleged that the company made misleading disclosures by disclosing information related to its channel health that only included channel partners to which the company sold directly, without disclosing that this information did not include channel partners to which the company sold indirectly. The company agreed to pay a $6 million penalty, without admitting or denying wrongdoing.

In December, the SEC announced the settlement of an action filed in February against an energy company and its subsidiary for making misleading statements by claiming that the company would qualify for large tax credits for which the company knew it likely would not be eligible.[23] According to the SEC, the company represented that its project to build two new nuclear power units was on schedule, and therefore, would likely qualify for more than $1 billion in tax credits, when the company knew its project was substantially delayed and, resultingly, likely would fail to qualify for these tax credits. Without admitting or denying the allegations, the company agreed to pay a $25 million penalty; the company and its subsidiary also agreed to pay $112.5 million in disgorgement and prejudgment interest. The settlement remains subject to court approval. The

litigation against two of the company's senior executives remains ongoing.

Also in December, the SEC filed a complaint against a brand-management company with violations of the federal securities laws' related to the company's alleged failure to account for and disclose evidence of goodwill impairment.[24] The complaint alleged that the company unreasonably concluded that its goodwill was not impaired based on a qualitative impairment analysis, without taking into account, and also without disclosing, two internal quantitative analyses showing that goodwill was likely impaired. The litigation against the company remains ongoing.

Internal Controls

Increasingly, the SEC has demonstrated a willingness to resolve investigations of public companies on the basis of violations of the internal controls provisions of the Exchange Act. One recent example of an internal controls settlement provided a rare window into a significant divergence of opinion among the Commissioners concerning the appropriateness of such settlements based on a broad application of the internal controls provision.

In October, the SEC instituted a settled action against an energy company related to charges that the company failed to maintain internal controls that would have provided reasonable assurance that the company's stock buyback plan would have complied with its own buyback policies.[25] According to the SEC's order, the company implemented a $250 million stock buyback while in possession of material nonpublic information (MNPI) about a potential acquisition, in spite of the company's policy prohibiting repurchasing stock while in possession of MNPI. In addition to detailing the litany of factors illustrating that the probability of the acquisition was sufficiently high as to have constituted MNPI, the SEC's order focused on the company's insufficient process for evaluating whether the acquisition discussions were material at the time it adopted a 10b5-1 plan for the buyback. Specifically, the process did not include speaking with the individuals at the company reasonably likely to have material information about significant corporate developments. As a result, the SEC's order alleged that the company's legal department did not consult with the CEO about the prospects of the company being acquired, even though the CEO was the primary negotiator. The company's legal department thus "failed to appreciate" that the transaction's probability was high enough to constitute MNPI.

Despite these findings, the SEC did not bring insider trading charges, but instead alleged that the company's internal controls were insufficient to provide reasonable assurance that the company's buyback transactions would comply with its buyback policy. Without admitting or denying the allegations, the company agreed to pay a $20 million penalty. Notably, Republican Commissioners Roisman and Peirce dissented from the Commission's decision to institute the enforcement action. In a public statement explaining their dissent, the Commissioners argued that the internal controls provision, Section 13(b)(2)(B) of the Exchange Act, applies to "internal *accounting* controls," and thus does not apply to internal controls to ensure a company does not repurchase stock in compliance with company policies.

Notes

1. Paul Kiernan and Scott Patterson, "An Old Foe of Banks Could Be Wall Street's New Top Cop," *Wall Street Journal*, Jan. 16, 2021, available at *https://www.wsj.com/articles/an-old-foe-of-banks-could-be-wall-streets-new-top-cop-11610773211*.
2. SEC Press Release, SEC Charges Companies, Former Executives as Part of Risk-Based Initiative (Sept. 28, 2020), available at *https://www.sec.gov/news/press-release/2020-226*.
3. SEC Press Release, SEC Charges BorgWarner for Materially Misstating its Financial Statements (Aug. 26, 2020), available at *https://www.sec.gov/news/press-release/2020-195*.
4. SEC Press Release, SEC Charges Super Micro and Former CFO in Connection with Widespread Accounting

© 2021 CCH Incorporated and its affiliates. All rights reserved.

Violations (Aug. 25, 2020), available at *https://www.sec.gov/news/press-release/2020-190*.

5. SEC Press Release, Engine Manufacturing Company to Pay Penalty, Take Remedial Measures to Settle Charges of Accounting Fraud (Sept. 24, 2020), available at *https://www.sec.gov/news/press-release/2020-222*.
6. SEC Press Release, SEC Charges Lighting Products Company and Four Executives with Accounting Violations (Sept. 24, 2020), available at *https://www.sec.gov/news/press-release/2020-221*.
7. SEC Press Release, SEC Charges BMW for Disclosing Inaccurate and Misleading Retail Sales Information to Bond Investors (Sept. 24, 2020), available at *https://www.sec.gov/news/press-release/2020-223*.
8. SEC Press Release, SEC Charges Manitex International and Three Former Senior Executives with Accounting Fraud (Sept. 29, 2020), available at *https://www.sec.gov/news/press-release/2020-237*.
9. SEC Press Release, SEC Charges Seismic Data Company, Former Executives with $100 Million Accounting Fraud (Oct. 8, 2020), available at *https://www.sec.gov/news/press-release/2020-251*.
10. SEC Press Release, SEC Charges Former Wells Fargo Executives for Misleading Investors About Key Performance Metric (Nov. 13, 2020), available at *https://www.sec.gov/news/press-release/2020-281*.
11. SEC Press Release, Luckin Coffee Agrees to Pay $180 Million Penalty to Settle Accounting Fraud Charges (Dec. 16, 2020), available at *https://www.sec.gov/news/press-release/2020-319*.
12. *See, e.g.*, Praxsyn Corp., Applied Biosciences Corp., and Turbo Global partners Inc.
13. SEC Press Release, SEC Orders Top Executive of California Microcap Company for Misleading Claims Concerning COVID-19 Test and Financial Statements (Sept. 25, 2020), available at *https://www.sec.gov/news/press-release/2020-224*.
14. SEC Press Release, SEC Charges Biotech Company and CEO with Fraud Concerning COVID-19 Blood Testing Device (Dec. 18, 2020), available at *https://www.sec.gov/news/press-release/2020-327*.
15. SEC Press Release, SEC Charges the Cheesecake Factory for Misleading COVID-19 Disclosures (Dec. 4, 2020), available at *https://www.sec.gov/news/press-release/2020-306*.
16. SEC Press Release, General Electric Agrees to Pay $200 Million Penalty for Disclosure Violations (Dec. 9, 2020), available at *https://www.sec.gov/news/press-release/2020-312*.
17. SEC Press Release, Fiat Chrysler Agrees to Pay $9.5 Million Penalty for Disclosure Violations (Sept. 28, 2020), available at *https://www.sec.gov/news/press-release/2020-230*.
18. SEC Press Release, SEC Charges Hospitality Company for Failing to Disclose Executive Perks (Sept. 30, 2020), available at *https://www.sec.gov/news/press-release/2020-242*.
19. SEC Press Release, Pharmaceutical Company and Former Executives Charged with Misleading Financial Disclosures (July 31, 2020), available at *https://www.sec.gov/news/press-release/2020-169*.
20. SEC Press Release, SEC Charges Hertz's Former CEO with Aiding and Abetting Company's Financial Reporting and Disclosure Violations (Aug. 13, 2020), available at *https://www.sec.gov/news/press-release/2020-183*.
21. SEC Press Release, SEC Charges Charter School Operator and its Former President with Fraudulent Municipal Bond Offering (Sept. 14, 2020), available at *https://www.sec.gov/news/press-release/2020-208*.
22. SEC Press Release, SEC Charges HP Inc. with Disclosure Violations and Control Failures (Sept. 30, 2020), available at *https://www.sec.gov/news/press-release/2020-241*.
23. SEC Press Release, Energy Companies Agree to Settle Fraud Charges Stemming from Failed Nuclear Power Plant Expansion (Dec. 2, 2020), available at *https://www.sec.gov/news/press-release/2020-301*.
24. SEC Press Release, SEC Charges Sequential Brands Group Inc. with Deceiving Investors by Failing to Timely Impair Goodwill (Dec. 11, 2020), available at *https://www.sec.gov/news/press-release/2020-315*.
25. SEC Press Release, SEC Charges Andeavor for Inadequate Controls Around Authorization of Stock Buyback Plan (Oct. 15, 2020), available at *https://www.sec.gov/news/press-release/2020-258*.

SECURITIES LITIGATION

Ninth Circuit Holds that a Whistleblower Action May Qualify as a "Corrective Disclosure"

A Ninth Circuit decision may erode some of the protections for securities class action defendants that Congress intended to provide in the Private Securities Litigation Reform Act. It also provides no guidance as to how public companies can take steps to avoid the challenges of allegations in a whistleblower complaint.

By Glenn K. Vanzura and Kevin C. Kelly

On October 8, 2020, the US Court of Appeals for the Ninth Circuit reversed the dismissal of a securities fraud class action against San Diego-based BofI Holding, Inc. (*BofI Holding*), now known as Axos Bank.[1] A majority of the appellate panel held that a former employee's fraud allegations in a whistleblower lawsuit may qualify as a "corrective disclosure" and may be used in the securities class action to plead loss causation under the Private Securities Litigation Reform Act of 1995 (PSLRA) as long as the whistleblower allegations are plausible, and even if there are no additional disclosures or evidence corroborating the allegations.

In so holding, the Ninth Circuit joined the Sixth Circuit in rejecting the "categorical rule that allegations in a lawsuit, standing alone, can never qualify as a corrective disclosure." In a dissenting opinion, one panelist expressed his preference for a bright-line rule that requires an external disclosure or evidence that confirms the allegations in a whistleblower lawsuit over the majority's approach, which he fears opens the door for meritless securities fraud suits that impose exorbitant costs on companies.

Glenn K. Vanzura *and* **Kevin C. Kelly** *are attorneys at Mayer Brown LLP.*

The Ninth Circuit's holding threatens to erode some of the protections Congress intended the PSLRA to provide to publicly traded companies and their officers and directors facing shareholder class actions. Specifically, *BofI Holding* may give shareholder plaintiffs a roadmap to new strategies for pleading two elements of a Section 10(b) claim: (1) loss causation and (2) scienter. When share price declines untethered to an actual revelation of fraud make pleading loss causation more challenging, *BofI Holding* gives plaintiffs another potential event that they may label a "corrective disclosure." In addition, while *BofI Holding* focuses on the loss causation element, its holding also seemingly gives additional weight to mere allegations in non-securities litigation, from which shareholder plaintiffs may attempt to plead particularized facts giving rise to a strong inference of scienter.

It remains to be seen how district courts will grapple with the Ninth Circuit's analysis and holding in *BofI Holding* when evaluating the plausibility of allegations in a whistleblower complaint. More concerning, there are few proactive steps issuers can take to avoid being subjected to costly securities litigation grounded in mere allegations made by a whistleblower in a separate suit.

Background

In *BofI Holding*, the district court dismissed the operative complaint on the grounds that the plaintiffs failed to adequately plead loss causation, one of six elements a plaintiff must plead to state a securities fraud claim. To plead loss causation, the complaint relied on two corrective disclosures, one of which was a whistleblower lawsuit filed in August 2015 by a former mid-level auditor at the company, alleging

© 2021 CCH Incorporated and its affiliates. All rights reserved.

rampant and egregious wrongdoing at the company. In dismissing the complaint, the district court reasoned that because the whistleblower lawsuit contained only "unconfirmed accusations of fraud," it could not have disclosed to the market that BofI's alleged misstatements were actually false. To qualify as a corrective disclosure, the lawsuit had to be followed by "a subsequent confirmation" of the fraud, which the shareholders had not alleged.

Failure to plead loss causation typically is not fertile grounds for a motion to dismiss.

That the district court dismissed the action with prejudice on these grounds is noteworthy, because a failure to plead loss causation typically is not fertile grounds for a motion to dismiss. Plaintiffs face a relatively low pleading bar to adequately allege loss causation. For example, where a company's stock suffers a substantial price decline, plaintiffs often are able to identify some public disclosure immediately preceding the price drop on which they can pin their loss causation allegations. In *BofI Holding*, because the plainitffs could not identify any such revelatory disclosure, they were forced to rely on, in the district court's view, unsubstantiated allegations made in a whistleblower lawsuit shortly before the relevant stock price decline.

Whistleblower's Lawsuit May Be Used to Plead Loss Causation

Reversing the district court's decision, the Ninth Circuit held that the plaintiffs alleged particularized facts plausibly suggesting that the market perceived the whistleblower's allegations as credible and acted upon them on the assumption that they were true. The whistleblower's descriptions of wrongdoing by the company were highly detailed, specific and based on firsthand knowledge that the whistleblower likely possessed by virtue of his position as a mid-level auditor at the company. Additionally, the plaintiffs alleged that BofI's stock price fell by more than 30 percent immediately after the market learned of the whistleblower's allegations. Thus, the Ninth Circuit joined the Sixth Circuit in rejecting the categorical rule that allegations in a lawsuit, standing alone, can never qualify as a corrective disclosure.

BofI Holdings is another decision in the Ninth Circuit's rollercoaster ride of analyses that attempt to distinguish between loss causation arguments based on the announcement of an investigation versus those based on the disclosure of insider allegations. In a 2014 decision, the Ninth Circuit held that a plaintiff could not rest his theory of loss causation on the announcement of an internal investigation alone because it did not reveal to the market any facts that could call into question the veracity of the company's prior statements. On the other hand, in a 2016 decision, the Ninth Circuit held that an announcement of a government investigation can qualify as a corrective disclosure for loss causation purposes if the inaccuracy of the misstatement at issue is subsequently confirmed. Then, in a 2017 decision, The Ninth Circuit rejected as inadequate a loss causation theory based on some 2,000 complaints the Federal Trade Commission had released to the public, because the complaints came from outsiders who lacked firsthand knowledge of the defendant's practices. *BofI Holding* seemingly indicates that plaintiffs may root their theory of loss causation in the disclosure of investigations or other complaints, where they are based both on plausible insider knowledge and where the disclosure allegedly suggests that a prior company disclosure was false or misleading.

Further, while the Ninth Circuit's holding is limited to the loss causation element, shareholder plaintiffs likely will use the Ninth Circuit's analysis as a springboard in some cases to attempt to plead scienter based on allegations made in whistleblower complaints. Securities class action plaintiffs often rely on confidential witness statements to establish scienter. This pleading tactic, however, has been an uphill battle. Federal courts' acceptance of confidential witnesses' statements has been begrudging.

Some circuits, including the Fifth and Seventh, steeply discount confidential witness allegations, and, in some instances, courts have determined that allegations attributed to confidential witnesses were misrepresented. Shareholder plaintiffs seeking new strategies to plead scienter may thus seize on the Ninth Circuit's holding to transform unverified whistleblower claims in a separate suit to alleged facts indicative of scienter in a shareholder class action.

Partial Dissent Prefers a Bright-Line Rule

Judge Lee dissented from the majority's holding that a whistleblower's lawsuit can qualify as a corrective disclosure for purposes of pleading loss causation. Judge Lee feared that the majority's decision

> will have the unintended effect of giving the greenlight for securities fraud lawsuits based on unsubstantiated assertions that may turn out to be nothing more than wisps of innuendo and speculation.

As Judge Lee explained, "even meritless securities fraud lawsuits impose an exorbitant cost on companies."

First, Judge Lee disagreed with the majority's conclusion that the whistleblower's allegations against BofI are plausible enough to constitute a corrective disclosure. Indeed, BofI has not issued any financial disclosures that would confirm the whistleblower's allegations and in the five years that have passed since the whistleblower alleged misconduct at BofI, investigations commenced by multiple government agencies into BofI have adduced no evidence corroborating the allegations.

Second, Judge Lee disagreed with the majority's use of the plausibility standard under *Iqbal* and *Twombly* to analyze the allegations in the whistleblower's lawsuit. An insider account almost always will have a "patina of plausibility" because it likely will be based on some non-public allegation that cannot be easily disputed or rebutted at the pleading stage. The plausibility standard, therefore, provides little comfort to companies that may face securities fraud lawsuits based on unsubstantiated insider allegations.

Third, Judge Lee disagreed with the majority's analysis of the stock drop. The fact that BofI's shares plummeted 30 percent after the whistleblower publicly accused his former employer of fraud did not demonstrate that the whistleblower's allegations revealed the "truth" and acted as corrective disclosure. Rather, the whistleblower's lawsuit is better construed as a disclosure of "an added *risk* of future corrective action." Based on the foregoing, Judge Lee concluded that

> if a securities fraud lawsuit turns on insider allegations of wrongdoing in a whistleblower lawsuit, I would prefer a bright-line rule that requires an external disclosure or evidence that confirms those allegations.

Key Takeaways

Congress passed the PSLRA because it expressly recognized that securities class actions, including meritless suits, threaten to impose unduly burdensome costs on publicly traded companies and their directors and officers. Accordingly, for 25 years, the PSLRA's heightened pleading standards have stood as a bulwark—although imperfect in some cases—against such meritless suits. The Ninth Circuit's decision in *BofI Holding* may erode some of the protections for securities class action defendants that Congress intended to provide in the PSLRA.

For instance, in cases where shareholders cannot identify clear revelations to establish loss causation, *BofI Holding* provides an alternate route whereby shareholders might plead that an insider's allegations, even if there is no evidence or disclosure corroborating them, serve as a corrective disclosure for purposes of pleading loss causation. In addition, although securities class action plaintiffs' confidential witness allegations have been met with increasing skepticism

© 2021 CCH Incorporated and its affiliates. All rights reserved.

by courts over the past decade, *BofI Holding* may portend a new trend in securities class actions, in which shareholder plaintiffs seize on unsubstantiated (and possibly meritless) whistleblower complaints as a foundation for pleading not just loss causation, but also scienter. More aggressive plaintiffs may even attempt to marry their whistleblower practice with their securities class action practice by, for example, using the whistleblower practice to file complaints to drive loss causation events and supposed evidence of scienter, on which the securities class action practice can then piggyback.

It remains to be seen how district courts within the Ninth Circuit will apply *BofI Holding* when evaluating the veracity of whistleblower allegations to determine if they bear the level of plausibility that the Ninth Circuit deemed to qualify as a corrective disclosure. Indeed, the dividing line between "plausible" and "implausible" whistleblower allegations that drive adequate indicia of loss causation is, as the *BofI Holding* dissent suggested, likely to remain blurry for some time. Notably, the Ninth Circuit placed great weight on the former employer's personal knowledge of the facts he alleged in his whistleblower complaint. But as the partial dissent questioned, what if the whistleblower, as a fairly junior-level former employee, was mistaken because he did not understand or have access to all the facts? It will be worth monitoring how district courts apply this challenging analysis when presented with future securities class action lawsuits that piggyback off whistleblower complaints. To date, four district court decisions in the Ninth Circuit have cited *BofI Holding*. In a November 2020 decision, the Southern District of California held that the alleged corrective disclosure, a *Bloomberg* article, bore almost no relation to the alleged misstatements or omissions, and thus lead plaintiff's reliance on *BofI Holding* was misguided.[2] The three decisions from the Northern District of California have addressed different findings from *BofI Holding* not related to the whistleblower lawsuit.[3]

Perhaps most concerning, the Ninth Circuit's decision provides no guidance as to how public companies might take proactive steps to avoid the challenges that befell BofI. It goes without saying that a company has no say or control over the content or nature of mere allegations lodged in a whistleblower complaint. As such, even if mindful of the Ninth Circuit's *BofI Holding* decision, there are no readily apparent measures companies can implement to avoid this sort of quagmire. The uncertainty facing both district courts and publicly traded companies subject to securities class actions lends credence to Judge Lee's preference for a bright-line rule requiring an external disclosure or evidence confirming allegations contained in an insider's complaint. Such a bright-line rule would hew more closely to Congress's clear intent to shield companies from the burdens and expense of shareholder class actions premised on mere allegations and unsubstantiated innuendo.

Notes

1. In re BofI Holding, Inc. Sec. Litig., 977 F.3d 781 (9th Cir. 2020).
2. Khoja v. Orexigen Therapeutics, Inc., 2020 WL 6395629 (S.D. Cal. Nov. 2, 2020).
3. Mulquin v. Nektar Therapeutics, 2020 WL 7773580 (N.D. Cal. Dec. 30, 2020); Ferraro Family Found, Inc. v. Corcept Therapeutics Inc., 2020 WL 6822916 (N.D. Cal. Nov. 20, 2020); Sayce v. Forescout Techs, Inc., 2020 WL 6802469 (N.D. Cal. Nov. 19, 2020).

IN THE COURTS

DC Circuit Holds that *Kokesh* Does Not Preclude Imposition of Industry Bars

By Joel Kurtzberg, Brad Bondi, Adam Mintz, and Grace McAllister

In *Kokesh* v. *SEC* (*Kokesh*),[1] the Supreme Court of the United States held that disgorgement is a penalty and, therefore, any attempt by the US Securities and Exchange Commission (SEC or Commission) to seek disgorgement is subject to 28 U.S.C. § 2462, which sets forth a five-year statute of limitations that applies to the enforcement of penalties.[2] The SEC traditionally has relied on its broad power to seek disgorgement to enforce the securities laws. After *Kokesh*, there was discussion that the decision would curtail or possibly eliminate the SEC's ability to use disgorgement and other equitable remedies, such as industry bars.[3]

In *Saad* v. *SEC*,[4] the Court of Appeals for the District of Columbia Circuit (DC Circuit) held, in a matter of first impression for the circuits, that *Kokesh* does not restrict the SEC's ability to impose industry bars. The petitioner argued that, under *Kokesh's* reasoning, industry bars are punitive and would constitute an impermissible sanction under Section 19(e)(2) of the Securities Exchange Act of 1934 (Exchange Act). The DC Circuit rejected that argument, holding that *Kokesh* is limited to an interpretation of Section 2462 and does not apply to other statutory provisions, including Section 19(e)(2) of the Exchange Act. With this decision, the DC Circuit joins several circuits that have refused to apply *Kokesh* beyond Section 2462.

Joel Kurtzberg, Brad Bondi, Adam Mintz, *and* **Grace McAllister** *are attorneys at Cahill Gordon & Reindel LLP. The views expressed herein are the views solely of the authors and are not necessarily the views of the firm or its clients.*

Kokesh and Open Questions as to Breadth

In *Kokesh*, the Supreme Court addressed whether disgorgement is a "penalty" under 28 U.S.C. § 2462, which sets forth a five-year statute of limitations that applies to any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise." Deciding that disgorgement was a penalty and not remedial, the Supreme Court established two principles to distinguish punitive from remedial sanctions. First, a punitive sanction or penalty "turns in part on whether the wrong sought to be redressed is a wrong to the public, or a wrong to the individual."[5] Second, a penalty is a sanction that is sought "for the purpose of punishment, and to deter others from offending in like manner—as opposed to compensating a victim for his loss."[6]

Under these principles, the Supreme Court in *Kokesh* found that disgorgement was a penalty under Section 2462 because it is imposed for a wrong "committed against the United States rather than an aggrieved individual" and because "[t]he primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains."[7] The Supreme Court highlighted that "SEC disgorgement is imposed for punitive purposes" and rejected the government's argument that disgorgement is remedial, or operating to restore the status quo.[8] "Sanctions imposed for the purpose of deterring infractions of public laws are inherently punitive because deterrence is not a legitimate non-punitive governmental objective."[9]

Following *Kokesh*, questions remained as to whether the Supreme Court's distinction between penalties and remedial measures would apply outside

© 2021 CCH Incorporated and its affiliates. All rights reserved.

of the Section 2462 context and, therefore, curtail or eliminate the SEC's ability to impose certain types of equitable relief, such as industry bars. Several circuits have refused to apply *Kokesh* beyond the narrow statute of limitations context.[10] Until *Saad* v. *SEC*, however, no circuit court had addressed directly whether *Kokesh* applies to statutes involving industry bars or debarments.

In *Saad* v. *SEC*, an industry bar was issued by the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization that provides oversight of broker-dealers. Under Section 19(e)(2) of the Exchange Act, the SEC may overturn or reduce a sanction imposed by FINRA for two reasons, if it finds that (1) the sanction "imposes any burden on competition not necessary or appropriate," or (2) the sanction is "excessive or oppressive."[11] A sanction that is penal or punitive, as opposed to remedial, typically is considered "excessive or oppressive" and therefore would be impermissible under the statute.[12]

Factual and Procedural Background

John M.E. Saad (Saad) was a FINRA-registered broker-dealer at an affiliate of Penn Mutual Life Insurance Company (Penn Mutual) called Hornor, Townsend & Kent, Inc., a FINRA member firm. In July 2006, Saad was scheduled to go on a business trip from Atlanta to Memphis, but the trip was cancelled and he instead checked into an Atlanta hotel. Following the "trip," Saad submitted false expense reports to his employer for air travel, his hotel, and drinks in the hotel lounge. He also submitted a false reimbursement for a replacement cellphone that he purchased for a potential Penn Mutual recruit. Penn Mutual's office administrator discovered Saad's misconduct, and Saad was fired.

FINRA investigated Saad, who repeatedly lied about his misconduct. In September 2007, FINRA brought a disciplinary proceeding against Saad for violation of FINRA Rule 2010 (at the time, NASD Rule 2110), which states that "[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."[13] The FINRA hearing panel imposed an industry bar, permanently banning Saad from associating with any FINRA member firm. Saad appealed the ruling pursuant to Section 19(e)(2) of the Exchange Act, which states that the SEC may review any disciplinary action or sanction taken by FINRA.[14] The SEC sustained the findings of FINRA, holding that "FINRA's decision to bar Saad is neither excessive nor oppressive and that the sanction serves a remedial rather than punitive purpose."[15]

Saad then petitioned the DC Circuit for review of the SEC's decision. The DC Circuit held that the SEC "abused its discretion when it affirmed FINRA's imposition of a lifetime bar" because it failed "to address several potentially mitigating factors," such as Saad's stress level and personal issues.[16] The case went back to FINRA to assess the mitigating factors. FINRA determined the industry bar was still warranted, and the SEC again affirmed.[17] Saad petitioned the DC Circuit for review for a second time, arguing that insufficient weight was given to mitigating factors and, in any event, that the industry bar was "impermissibly punitive rather than remedial."[18] The DC Circuit held that while the SEC "reasonably balanced the relevant mitigating and aggravating factors before determining that the gravity of Saad's behavior warranted remedial action," the SEC also must consider whether *Kokesh* had any impact on the SEC's ability to impose a lifetime industry bar.[19] On remand, the Commission concluded that *Kokesh* had "no bearing on the determination that the FINRA disciplinary action should be sustained."[20] Saad again petitioned the DC Circuit for review of the SEC's order.

The DC Circuit Affirms the Industry Bar

Addressing the lifetime bar for a third time, the DC Circuit refused to extend *Kokesh's* reasoning beyond Section 2462. First, the court explained that the Supreme Court in *Kokesh* expressly limited its holding to the narrow facts of its case—that is, to disgorgements under Section 2462. Second,

the court observed that, under DC Circuit precedent, general principles for distinguishing between punitive and remedial sanctions do not exist. For example, the DC Circuit has concluded that a professional suspension is a penalty in a Section 2462 inquiry following a similar approach to that in *Kokesh*.[21] Yet, the DC Circuit also has held that a lifetime bar against a NASD member was remedial under Section 78s(e)(2) because the purpose of the bar was not to punish but to protect the public.[22] Third, the DC Circuit indicated that "Supreme Court precedent confirms that *Kokesh* has no bearing on the Exchange Act."[23] In *Liu* v. *SEC,*[24] the Supreme Court held that disgorgement was permissible as equitable relief under Section 21(d)(5) of the Exchange Act, which "historically excludes punitive sanctions."[25] "The [Supreme] Court declined to reflexively apply *Kokesh* and instead independently analyzed the meaning of 'remedial' within the separate set of cases relevant to the statutory inquiry."[26] Finally, the DC Circuit indicated that using *Kokesh* to prohibit debarments under the Exchange Act as "impermissibly punitive" would conflict with other portions of the Exchange Act which expressly authorize them.

Implications

In *Saad* v. *SEC*, the DC Circuit upheld the permanent industry bar authorized by FINRA and confirmed by the SEC under the Exchange Act. The court held that *Kokesh's* reasoning for distinguishing between punitive and remedial sanctions does not apply across legal contexts and is restricted to the statute that *Kokesh* specifically addressed, Section 2462. The DC Circuit, therefore, joins several other Courts of Appeal that have refused to apply *Kokesh* beyond Section 2462.

Notes

1. Kokesh v. SEC, 137 S. Ct. 1635 (2017).
2. On January 1, 2021, Congress passed the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021 (H.R. 6395) (NDAA), which expressly allows the SEC to seek disgorgement in federal district court and expands the statute of limitations for disgorgement to 10 years in cases in which scienter must be established. The NDAA effectively overrules the portion of *Kokesh* that limits disgorgement in all cases to a five-year statute of limitations. The NDAA is silent on equitable principles imposed by *Kokesh* and other courts in relation to disgorgement, such as whether disgorgement is punitive or remedial.
3. *See, e.g.*, "Supreme Court Holds That Five-Year Statute of Limitations Applies to SEC Disgorgement Actions, (June 12, 2017), available *at https://www.cahill.com/publications/firm-memoranda/2017-06-12-supreme-court-holds-that-five-year-statute-of-limitations-applies-to-sec-disgorgement-actions*.
4. Saad v. SEC, 980 F.3d 103 (DC Cir. Nov. 6, 2020).
5. *Kokesh*, 137 S. Ct. at 1642.
6. *Id*.
7. *Id*.
8. *Id*. at 1643.
9. *Id*.
10. *See, e.g.*, United States v. Ellis, 938 F.3d 757, 765 (6th Cir. 2019) (declining to apply *Kokesh* to restitution obligation under Mandatory Victims Restitution Act); United States v. Dyer, 908 F.3d 995, 1003 (6th Cir. 2018) (*Kokesh* analysis not applicable to Double Jeopardy Clause); Jalbert v. SEC, 945 F.3d 587, 591-592 (1st Cir. 2019) (declining to apply *Kokesh* to SEC's statutory authority to seek disgorgement in administrative proceedings); Fed. Trade Comm'n v. AMG Capital Mgmt., LLC, 910 F.3d 417, 426-427 (9th Cir. 2018) (*Kokesh* not applicable to Federal Trade Commission's authority to obtain restitution).
11. 15 U.S.C. § 78s.
12. *See, e.g.*, McCarthy v. SEC, 406 F.3d 179, 188 (2d Cir. 2005).
13. *Saad*, 980 F.3d at 104.
14. 15 U.S.C. § 78s(d)–(e).
15. In the Matter of the Application of John M.E. Saad for Review of Disciplinary Action Taken by FINRA, Release No. 62178 (May 26, 2010).
16. *Saad* v. *SEC*, 718 F.3d 904, 912 (D.C. Cir. Jun. 11, 2013).
17. In the Matter of the Application of John M.E. Saad for Review of Disciplinary Action Taken by FINRA, Release No. 70632 (Oct. 8, 2013) (SEC order remanding case to FINRA for review of mitigating factors); In the Matter of the

© 2021 CCH Incorporated and its affiliates. All rights reserved.

Application of John M.E. Saad for Review of Disciplinary Action Taken by FINRA, Release No. 76118 (Oct. 8, 2015) (SEC order sustaining FINRA's determination that industry bar remains).

18. *Saad* v. *SEC*, 873 F.3d 297, 298 (D.C. Cir. Oct. 13, 2017).
19. *Id.* at 302 (D.C. Cir. Oct. 13, 2017).
20. *In the Matter of the Application of John M.E. Saad for Review of Disciplinary Action Taken by FINRA*, Release No. 86751 (Aug. 23, 2019).
21. *See* Johnson v. SEC, 87 F.3d 484, 491–92 (D.C. Cir. June 21, 1996).
22. *See* PAZ Sec., Inc. v. SEC, 566 F.3d 1172, 1175 (D.C. Cir. May 29, 2009).
23. *Saad*, 980 F.3d at 107–08.
24. *Liu* v. *SEC,* 140 S. Ct. 1936 (2020).
25. *Id.*
26. *Id.* at 108. *See also* Supreme Court Holds That SEC Disgorgement Is a Form of Equitable Relief (July 27, 2020), available at *https://www.cahill.com/publications/firm-memoranda/2020-07-27-supreme-court-holds-that-sec-disgorgement-is-a-form-of-equitable-relief*.

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Alston & Bird LLP
Washington, DC (202-756-3300)

Resource Extraction Issuers Must Report Payments to Governments (January 4, 2021)

A discussion of the Securities Exchange Commission's (SEC) adoption of a rule to implement Section 13(q) of the Securities Exchange Act of 1934 (Exchange Act). Pursuant to the rule, oil, natural gas and mining companies will be required to provide information about the type and total amount of payments made to a foreign government for each of their projects related to the commercial development of resources.

SEC Proposes Amendments to Rule 144 and Form 144 (January 6, 2021)

A discussion of the SEC's proposal of amendments to Rule 144 to eliminate the "tacking" of holding periods for "market-adjustable" convertible securities and to revise Form 144 notice of sale.

Arnold & Porter Kaye Scholer LLP
Washington, DC (202-942-5000)

SEC Finalizes Final Rule Modernizes Statistical Disclosures for Banking Registrants (January 14, 2021)

A discussion of the SEC's adoption of a rule that substantially updates and expands statistical disclosure requirements for bank and savings and loan registrants that currently are set forth in Industry Guide 3.

Ballard Spahr LLP
Philadelphia, PA (215-665-8500)

SEC Settles Charges against Municipal Underwriter for Unfair Practices and Misleading Advertising (January 4, 2021)

A discussion of SEC settled charges against an underwriter, its owner, and chief compliance officer for violations of Municipal Securities Rulemaking Board Rules G-21 on misleading advertising and G-17 on fair dealing for selling new issue municipal securities to broker-dealers.

Bryan Cave Leighton Paisner LLP
St. Louis, MO (314-259-2000)

Key Takeaways and Reminders for 2021 Form 10-K and Proxy Season (January 22, 2021)

A discussion of the key issues and changes that companies should consider as they continue to work on Form 10-K and proxy statement matters.

Davis Polk & Wardwell LLP
New York, NY (212-450-4000)

NYSE Proposes Relaxation of Shareholder Approval Rules (January 1, 2021)

A discussion of New York Stock Exchange (NYSE) proposed rules that would relax its current requirements to obtain shareholder approval prior to certain equity issuances.

© 2021 CCH Incorporated and its affiliates. All rights reserved.

Debevoise & Plimpton LLP
New York, NY (212-909-6000)

The SEC's Expanded Disgorgement Authority Complicates Investigations and Settlements (January 4, 2021)

A discussion of the passage of the National Defense Authorization Act for fiscal year 2021, which, among other things, amends the Exchange Act to codify, refine, and expand the SEC's ability to seek disgorgement and other equitable relief for violations of the federal securities laws.

SEC Announces Reg BI-Focused Examinations to Begin January 2021 (January 7, 2021)

A discussion of the release by the SEC's renamed Division of Examinations (formerly the Office of Compliance Inspections and Examinations) of updated guidance concerned its planned examination program involving Regulation Best Interest.

Dechert LLP
Philadelphia, PA (215-994-4000)

New SEC Proposal Modernizes Rule 701 and Form S-8 (January 5, 2021)

A discussion of the SEC's proposal of temporary rules that would permit companies to offer equity compensation to "platform workers" who provide services available through the company's technology-based platform. The proposals would amend Rule 701 under the Securities Act of 1933 and Form S-8.

Dorsey & Whitney LLP
Minneapolis, MN (612-340-2600)

SEC Enforcement: The Fourth Quarter of 2020 (January 2021)

A discussion of SEC enforcement activity during the fourth quarter of calendar year 2020, including fraud cases, those involving investment advisers, and in the corporate disclosure and financial area.

Eversheds-Sutherland Ltd.
Atlanta, GA (404-853-8000)

Diversity Boost in the Boardroom (January 5, 2021)

A discussion of the Nasdaq rule proposal filed with the SEC to adopt listing rules that would enhance board diversity and transparency among companies listed on its exchange.

SEC Modernizes Valuation Practices (January 2, 2021)

A discussion of the SEC's adoption of new Rule 2a-5 under the Investment Company Act of 1940 (1940 Act), which establishes a framework for fund valuation practices and clarifies how the board of directors of a fund can satisfy its valuation obligations under the 1940 Act.

Fried, Frank, Harris, Shriver & Jacobson LLP
New York, NY (212-859-6600)

SEC Adopts Revised Investment Adviser Marketing Rule (January 4, 2020)

A discussion of the SEC's adoption of amendments to modernize and consolidate Rules 206(4)-1 (Advertising Rule) and Rule 206(4)-3 (Solicitation Rule) under the Investment Advisers Act of 1940.

Gibson, Dunn & Crutcher LLP
Los Angeles, CA (213-329-7870)

Open Questions Remain after SEC Approves Primary Direct Listings on the NYSE (January 8, 2021)

A discussion of the new questions and challenges raised by primary offerings through direct listings now that they are permitted by the NYSE.

Supreme Court Vacates Second Circuit Ruling Expanding Insider Trading Liability (January 13, 2021)

A discussion of the US Supreme Court's summary disposition in *United States v. Blaszcak,* a major insider trading case, in light of the Supreme Court's decision in *Kelly v. United States*.

Ninth Circuit Upholds Broad Protection for Corporate Officer Making Forward-Looking Statements (January 29, 2021)

A discussion of a US Court of Appeals for the Ninth Circuit decision, *Wochos v. Tesla, Inc*., reaffirming the broad protections afforded to corporations and their officers when speaking about a company's future plans and projections.

Hughes Hubbard & Reed LLP
New York, NY (212-837-6000)

Board and Board Committees and Litigation among Conflicted Parties (January 11, 2021)

A discussion of a Delaware Court of Chancery decision, *In Re WeWork Litigation*, deciding that a later-appointed committee of the board of directors could not withdraw a lawsuit that a previously-appointed special committee had filed on the company's behalf.

KattenMuchinRosenman LLP
Chicago, IL (312-902-5200)

New York Adopts New Registration and Examination requirements for Certain Investment Adviser Related Personnel and Solicitors (January 28, 2021)

A discussion of new amended rules in New York that require certain individuals associated with investment advisers to register with the state and meet examination requirements (or qualify for exemptions therefrom).

Kirkland & Ellis LLP
Chicago, IL (312-862-2000)

OCIE Issues Observations on Investment Adviser Compliance Programs (December 30, 2020)

A discussion of a risk alert issued by the SEC Office of Compliance Inspections and Examinations (OCIE) that sets forth compliance issues related to the Compliance Rule under the Advisers Act.

Latham & Watkins LLP
Los Angeles, CA (213-485-1234)

Second Circuit Affirms SEC's Bank Secrecy Powers (January 11, 2021)

A discussion of a US Court of Appeals for the Second Circuit decision, *SEC v. Alpine Securities Corp*., affirming the SEC's authority to require SEC-registered broker-dealers to comply with the Bank Secrecy Act's reporting and recordkeeping requirements.

Mayer Brown LLP
Chicago, IL (312-782-0600)

SEC Staff Issues No-Action Relief for Custody of Certain Loan Interests under the 1940 Act (January 22, 2021)

A discussion of a no-action letter issued by the SEC Staff to certain registered management investment companies and series and their officers and directors with respect to the funds acting as self-custodians.

© 2021 CCH Incorporated and its affiliates. All rights reserved.

Mintz, Levin, Cohn, Ferris, Glovsky &Popeo P.C.
Boston, MA (617-542-6000)

How Companies Can Prepare for Proxy Advisor Reform (January 21, 2020)

A discussion of newly effective SEC rules governing voting advice provided by proxy advisory firms and next steps for companies to consider.

Paul, Weiss, Rifkind, Wharton & Garrison LLP
New York, NY (212-373-3000)

SEC Division of Corporation Finance Issues SPAC Disclosure Guidance (January 4, 2020)

A discussion of the issuance by the SEC Division of Corporation Finance of CF Disclosure Guidance: Topic 11—Special Purpose Acquisition Companies (SPACs), which highlights disclosure considerations for SPACs at both the initial public offering and business combination stages.

Sidley Austin LLP
Chicago, IL (312-853-7000)

SEC Adopts Rules to Modernize Equity Market Data Content and Infrastructure (January 7, 2021)

A discussion of the SEC's adoption of amendments to the content of consolidated market data for equities and the manner in which such data is distributed to market participants.

Skadden, Arps, Slate, Meagher & Flom LLP
New York, NY (212-735-3000)

Sustainability and ESG: The Governance Factor (January 11, 2021)

A discussion of recommendations for companies seeking to improve their corporate governance framework with respect to board diversity, compliance, risk management, and stockholder engagement.

Priorities to Shift for Biden's SEC (January 26, 2021)

A discussion of how the SEC's regulatory and enforcement priorities are poised to shift under President Biden.

U.S. Corporate Governance: The Ascension of ESG (January 26, 2021)

A discussion of the likelihood that the SEC will be much more receptive to meaningful and comparable company disclosures across a spectrum of environmental, social, and corporate governance (ESG) topics and investors placing more scrutiny on how companies are interacting with their stakeholders.

Steptoe & Johnson LLP
Washington, DC (202-429-8088)

FCPA/Anti-Corruption Developments: 2020 Year in Review (January 19, 2021)

A discussion of enforcement, regulatory and litigation developments with respect to the Foreign Corrupt Practices Act (FCPA) in 2021.

Venable LLP
Baltimore, MD (410-244-7400)

Proxy Materials and Annual Meetings under Maryland Law—2021 (January 15, 2021)

A discussion of matters of Maryland law relating to proxy materials and annual meetings and key issues for 2021 annual meetings.

INSIDE THE SEC

Highlights from the 48th Annual San Diego Securities Regulation Institute

By Aaron Briggs, Courtney Haseley, Lauren Assaf-Holmes, and Zachariah Lloyd

At the 48th Annual Securities Regulation Institute, sponsored by Northwestern Pritzker School of Law, held virtually January 25-27, 2021, former Securities and Commission (SEC) chairs, various senior SEC Staff and a number of practitioners discussed a wide variety of current securities law and related issues. The conference covered topics ranging from proxy season trends to recently adopted SEC rules, recent SEC guidance, SEC enforcement updates, and trends in COVID-19 and ESG-related disclosures.

The SEC in 2021–Looking Ahead

Richard H. Walker of King & Spalding moderated a discussion of former SEC chairs—Harvey L. Pitt of Kalorama Partners, Mary Schapiro of Bloomberg, and Mary Jo White of Debevoise & Plimpton—discussing a variety of subjects in response to the question: What will be the first priorities of the new SEC chair?

As background to the discussion, the panelists shared their experiences regarding the importance of rapidly defining and implementing a policy agenda, filling key senior staff positions that are inevitably created by personnel turnover, maintaining contact and good relations with the committees of Congress charged with oversight of the SEC, and how to seek and build consensus among the Commissioners in an increasingly partisan environment. Each of the panelists lamented the modern nominating process, which leads to increasingly divergent policy positions among the Commissioners as well as the communication barriers erected between them by the Sunshine Act. The panelists had a strong consensus that a foremost responsibility of an SEC chair is to seek to understand the views of his or her other Commissioners and to pursue consensus among them where possible, particularly with respect to enforcement actions.

Next, the panelists discussed a wide range of issues that are likely to be a focus of the incoming SEC chair, including as part of the chair's role to help implement certain aspects of the Biden Administration's platform. Specifically, the panelists discussed topics such as the ongoing evolution of the proxy rules, the current and potential future application of Regulation Best Interest, and the increasing importance of climate change and other environmental, social and governance (ESG) disclosures, including evolving standards in the private sector, how the SEC might seek to build cross-governmental coordination, and the challenges of encouraging consistent and comparable climate change disclosure that is also useful to investors. Finally, the panelists shared their perspectives on which agency is best suited to regulate digital assets, including a suggestion by former Commissioner White that a new agency be created in order to provide appropriate expertise and oversight, the evolution of capital formation and how the SEC can effectively protect investors in both private and public markets.

Aaron Briggs, Courtney Haseley, Lauren Assaf-Holmes, *and* **Zachariah Lloyd** *are attorneys at Gibson, Dunn & Crutcher LLP. Gibson Dunn attorneys Branden Berns and Bryan McCutcheon also contributed to this article.*

© 2021 CCH Incorporated and its affiliates. All rights reserved.

Recurring Disclosure Challenges

Thomas J. Kim of Gibson, Dunn & Crutcher moderated a discussion with panelists Michael L. Hermsen of Mayer Brown, P.J. Himelfarb of Weil, Gotshal & Manges, and Marko S. Zatylny of Ropes & Gray, focusing on disclosure challenges likely to be encountered by public companies over the next year, including the new human capital management requirements.

The panel first considered implementation of the new human capital management disclosure requirements under Item 101(c)(2)(ii) of Regulation S-K. One panelist pointed out that almost every company will need to discuss human capital in their 10-K, as human capital resources are likely to be material to an understanding of almost every company's business taken as a whole, save for highly unique situations. Because the disclosure requirement is principles-based, the panelists discussed the importance of avoiding boiler-plate disclosure and how to meet the objectives of the new disclosure requirement, including the spirit of the new rule as informed by the Commissioners' expectations expressed in the proposing and adopting releases.

The panelists discussed key questions a company should ask in preparing the new disclosure (*e.g.*, What have you already disclosed publicly? How would you describe your workforce?) and stressed the need for consistency with other public disclosures made regarding the company's workforce. They also discussed quantitative and qualitative measures that potentially could be disclosed (such as number of employees, employee categories, and workforce diversity metrics). Panelists considered how to handle prior disclosure in a sustainability report that included a human capital section, noting that the former should not dictate the disclosure included in the 10-K, although disclosure as between the two reports should not be inconsistent. Likewise, panelists considered how a company's intention to publish EEO-1 data might inform the content of the human capital disclosure in the 10-K, with some suggesting that certain companies may be keen to mention such intention and/or provide certain workforce metrics based on the EEO-1 data, although it is premature to anticipate trends in this regard. Overall, panelists shared the expectation that the new human capital disclosures are likely to face SEC scrutiny in the coming year (as is typical with new substantive disclosure requirements).

The panel also discussed considerations for restarting earnings guidance after withdrawing guidance in 2020 in connection with the pandemic. One panelist suggested that the evaluation should begin with a backwards-looking analysis to identify and understand what drove the company to stop providing earnings guidance in the first place and the degree to which the underlying concerns still exist and how those considerations have evolved. Other panelists echoed this approach and noted the importance of forward-looking analysis as well, to determine whether the company believes it now has confidence to provide earnings guidance and on what basis. The panelists generally agreed that there should be a reasonable basis for any projections provided, and consideration should be given to corresponding updates to the forward-looking statement disclaimer. One panelist, echoing the statements of former Chair Clayton, stressed the importance of clearly stating the assumptions that underlie the company's projections.

Finally, the panel discussed how a company might consider whether to restart its share buyback program, and whether such a decision should be disclosed publicly. Most stressed the importance of looking back to understand what the company said about stopping the program in the first place, including whether the company indicated that the program was suspended due to the pandemic, and noted that a number of materiality factors come into play, including the planned size of the buyback program, the degree to which the company would plan to resume its program in a meaningful way, and the company's size. Panelists also discussed the interplay between determining whether to restart a share buyback program and whether to restart earnings guidance, and timing considerations relevant to

both (*e.g.*, whether to make those changes before or after filing the 10-K).

Proxy and Annual Meeting Developments

Lillian C. Brown of Wilmer Cutler Pickering Hale and Dorr moderated a discussion with panelists Zally Ahmadi of D.F. King, Krystal Gaboury Berrini of PJT Camberview, and Keir D. Gumbs of Uber Technologies, focusing on lessons learned from the 2020 proxy season and trends and best practices headed into the upcoming proxy season.

The panel opened by discussing 2020 virtual annual meetings and the research and recommendations of the 2020 Multi-Stakeholder Working Group on Practices for Virtual Shareholder Meetings,[1] which found that 98 percent of the nearly 2,400 virtual meetings held in 2020 were audio-only and had an average attendance of 48 shareholders or guests. (*Editor's note: for further discussion of the Working Group's report, see the article by Chia, also appearing in this February 2021 issue of* INSIGHTS.) For companies holding a virtual meeting in 2021, the panel emphasized the importance of robust proxy disclosure and maintaining fairness in the process, particularly with regard to how investors can access the meeting and ask questions, including differences with respect to recordholders and street-name holders. Panelists also recommended publishing the meeting rules of conduct as early as possible and holding meeting dress rehearsals with the board and management.

Pivoting to hot topics for the upcoming proxy season, the panel first addressed board and workforce diversity. Panelists noted that pension funds and social impact investors are seeking increased disclosure on these topics, including publication of EEO-1 data, and that proxy advisors continue to increase their expectations around board diversity (both gender and race/ethnicity), with new voting policies for 2021. The panel turned to board oversight of risk, which the panel predicted will continue to be a focus for investors, noting that the board's involvement in navigating the challenges of COVID-19 and climate change are important issues to address in the proxy. On the topic of executive compensation, the panel emphasized that investors will be very focused on any adjustments made to metrics and targets as a result of COVID-19 and so companies should provide robust disclosure in the proxy explaining why those decisions were made. Regarding shareholder activism, the panel noted a large decrease early in 2020, save for a few activists, before activity rebounded in the second half of the year. As the pandemic has exposed companies' operational vulnerabilities, the panel predicted an increase in activism in 2021.

The panel then turned to the Staff's interpretation released in September 2020 related to the treatment of executive perks in the COVID-19 environment.[2] Although the Staff made clear that the SEC's perk analysis remained unchanged, the guidance was viewed as ineffective in helping companies determine when benefits that were not perks in a pre-COVID environment could become so when adapted to a working-from-home environment. For example, security provided to a CEO while working at a company office is not a perk, but security provided to that same CEO while working from home could be considered a perk. The panel underscored that perks remain a focus for the SEC's Division of Enforcement and that companies should be transparent in the proxy as to their decisions and rationale with regard to these matters.

The panel ended with a discussion of shareholder proposal trends. The 2020 proxy season saw an overall decrease in the number of proposals submitted. However, support increased for governance proposals (with significant support (nearly 80 percent) for reduce supermajority vote initiatives), social proposals (particularly in requests for EEO-1 reporting and board diversity) and environmental proposals (with six proposals receiving majority support).

© 2021 CCH Incorporated and its affiliates. All rights reserved.

Updates from SEC Senior Staff: Division of Enforcement and Office of the General Counsel

Dixie L. Johnson of King & Spalding moderated a panel of SEC Senior Staff—Richard R. Best, Director of the New York Regional Office, Division of Enforcement, Erin E. Schneider, Director of the San Francisco Regional Office, Division of Enforcement, and Michael A. Conley, Solicitor, Office of the General Counsel—discussing the latest trends and key topics in securities enforcement.

Ms. Schneider opened with trends she anticipates in her docket in the coming year. As for public companies, she noted that many face significant reporting issues with respect to qualitative statements in their disclosures—including management's discussion and analysis (MD&A), risk factors that may or may not have materialized, key-performance indicators, non-GAAP metrics and statements about regulatory approvals and new products—which may not be given the same robust internal review as financial statement disclosures. She also pointed to situations where companies are withholding information from their attorneys and auditors, which has led to significant problems in her region.

Mr. Best began with a discussion regarding the work of the Retail Strategy Task Force in dealing with cyber threats posed to both issuers and investors. He noted a 21(a) report from October 2018 relating to cyber-related frauds perpetrated against public companies which found that "business email compromises" have caused over $5 billion in losses since 2013.[3] The report explains what public companies should consider when dealing with cyber threats, implementing internal accounting controls, training personnel on those controls and key disclosure issues to consider when reporting on the occurrence of these cyber threats. Mr. Best also noted the operational challenges caused by the COVID-19 pandemic, including, for example, how inventory is managed, how auditing functions are performed and whether internal controls that are dependent on in-person interactions are still operating effectively.

The panelists discussed some of the key enforcement actions last year. Of note was the SEC's December 2020 settlement with Robinhood Financial.[4] Robinhood agreed to pay $65 million to settle charges that it "provided misleading information to customers about the true costs of choosing to trade with the firm." Ms. Schneider explained that Robinhood's claims that its trading platform was "commission free" is emblematic of a lot of the cases coming out of Silicon Valley where two key questions are: (1) whether a service is really "free," and (2) whether that is being fairly and accurately disclosed to customers and investors. Ms. Schneider also discussed the February 2020 settlement with Wells Fargo, pursuant to which it agreed to pay $500 million to settle charges related to inaccuracies in its "cross-sell metric."[5] She noted that where issuers tout metrics as being material and significant to their businesses, they need to establish robust controls and practices to ensure the accuracy of those metrics.

Mr. Conley noted the recent passage of the 2021 National Defense Authorization Act, a defense-spending bill which included provisions granting the SEC statutory authority to seek disgorgement in federal court with a statute of limitations for that remedy of 10 years. While noting that the Enforcement Division is still carefully evaluating the impacts of this law, Mr. Best stated that they will continue to ask for tolling agreements while they evaluate the evidence and determine which charges to bring.

Lastly, the panelists discussed challenges related to the COVID-19 pandemic. Mr. Best noted that his office is keeping a close eye on the micro-cap space—looking at claims made in press releases related to the pandemic. He highlighted the recent Cheesecake Factory settlement, in which the company was alleged to have made misleading statements related to the impact of the pandemic on

its business (*e.g.*, stating that its restaurants were "operating sustainably" during the pandemic when in fact the company was losing approximately $6 million in cash per week and had only 16 weeks of cash remaining).[6] Ms. Schneider noted that companies should be especially focused on their internal controls as employees continue to work remotely.

MD&A Disclosure: How to Do It Really, Really Well

Richard C. Blake of Wilson Sonsini Goodrich & Rosati moderated a discussion with panelists Karen J. Garnett of Proskauer Rose, Sandra J. Peters of CFA Institute, and Jimmy Yang of Citigroup, focusing on the SEC's most recent amendments to MD&A requirements and the panel's recommendations for effective disclosures.

Turning first to the January 2020 key performance indicator (KPI) guidance from the SEC,[7] the panel summarized three primary focus areas of the guidance: (1) the need to disclose KPIs in MD&A, (2) address changes in their definition, and (3) maintain effective disclosure controls and procedures that extend to disclosed KPIs. Overall, the panel highlighted the need for consistency from period to period in calculating KPIs, explaining assumptions underlying KPIs, and disclosing KPIs in MD&A in a matter that is not misleading. It was noted that the guidance is particularly relevant for companies that have or will provide ESG metrics (*e.g.*, around climate change).

The panel then focused on the most recent amendments to MD&A.[8] At a high-level, the panel characterized the changes as consolidating guidance, streamlining how rules are discussed, emphasizing a principles-based approach, eliminating immaterial and repetitive disclosure requirements, and focusing on materiality. The panel discussed the adopting release's framework for when known trends and uncertainties should be disclosed, highlighting the underlying implication that if the materiality or certainty of an event is unclear, it should be disclosed. In that regard, the panel considered the amendments to affirm the SEC's view that the traditional test for materiality—probability and magnitude—does not apply to MD&A. The panel noted that the updates would not apply for most companies until the Form 10-K for fiscal 2021, and that if any item (*e.g.*, Item 301, 302 or 303) is adopted early, such item, as amended, must be complied with in full.

To close, the panel provided their recommendations for preparing the MD&A. Before drafting, companies should think about the objective of the section—to help investors understand, through the eyes of management, what is material about the business. Companies should start early with the right team and consider the appropriate format for the discussion (*e.g.*, the inclusion of tables). It was noted that an executive summary or overview can be helpful. In preparing, companies should consider what was different about the period being discussed, such as transactions, accounting changes, or new products, and describe recent developments in the business. Further, companies should continue to ask and answer 'why' in order to identify the material drivers for discussion. The section should reflect management's voice, and senior executives should be consulted where their views on a matter are not known. Finally, companies should remember to be consistent in their discussions across the Form 10-K, corporate website, earnings materials and investor presentations, with the panelists noting that the Staff continues to review company disclosures outside of SEC filings for consistency.

Everything You Always Wanted to Know About Securities Law but Were Never Given the Chance to Ask

David M. Lynn of Morrison & Foerster moderated a discussion with panelists Dennis O. Garris of Alston & Bird, Shelly Heyduk of O'Melveny & Myers, and Scott Siamas of Salesforce, addressing questions submitted by conference attendees on a wide variety of topics.

The panel first discussed whether companies can choose to early adopt the SEC's recent MD&A

© 2021 CCH Incorporated and its affiliates. All rights reserved.

amendments (discussed above) in their upcoming Form 10-Ks. One panelist observed that, as a result of President Biden's January 20, 2021 executive action[9] directing federal agencies to "consider postponing" the effectiveness of issued rules that have not yet taken effect, until the February 10 effective date of the new rules, there was some risk that the effective date could be delayed. Another panelist noted that such a delay would require a vote of the Commissioners and speculated that it seemed unlikely that such a vote would be taken.

The panel then discussed how COVID-19 should be addressed in the risk factors. The panelists observed that the impact of COVID-19 on companies, along with companies' resulting disclosure practices, has been divergent and individualized. One panelist asserted that COVID-19 risk factors are still relevant for most issuers and should continue to be included in filings, noting that there are still major issues and uncertainties about COVID-19, including questions about the effectiveness and availability of vaccines, the impacts of new strains, and the likelihood of additional lockdowns. Another panelist emphasized the importance of revisiting prior COVID-19 risk factor discussions in connection with upcoming Form 10-K filings, as the risk profile may have changed. In line with recent SEC enforcement actions, another panelist cautioned companies to avoid using hypothetical language in risk factors to describe events that have actually happened.

The panel also discussed the use of electronic signatures for SEC filings. One panelist summarized the recently adopted amendments to Rule 302(b) of Regulation S-T and the EDGAR Filer Manual that became effective in December 2020.[10] Under the amended rules, before a signatory initially uses an electronic signature, the signatory must manually sign a document attesting that the signatory agrees that the use of an electronic signature in any authentication document pertaining to an EDGAR filing constitutes the legal equivalent of such individual's manual signature. This initial attestation must be retained for a minimum of seven years after the most recently electronically signed authentication document. It was suggested that companies consider proactively collecting an initial attestation document from any persons (such as incoming Section 16 officers and directors) who may need to electronically sign EDGAR documents in the future to make things easier on the back end at the time of filing.

In addition, the panel discussed the streamlined confidential treatment (CT) process that the SEC implemented in 2019 and further updated over the next year. With respect to continuing confidential treatment for an exhibit that had been redacted under the pre-streamlined rules and for which confidential treatment was about to expire, one panelist noted the Division of Corporation Finance's positions in CF Disclosure Guidance: Topic No. 7.[11] As set forth in Topic No. 7, companies that previously have obtained a confidential treatment order have three choices on how to proceed when a prior CT order is about to expire and the exhibit remains material: (1) refile the unredacted exhibit; (2) submit an application to extend the confidential period pursuant to the pre-streamlined rules (provided that for CT orders issued more than three years ago, companies will not be able to take advantage of the SEC's short-form application); or (3) transition to the streamlined rules governing the filing of redacted exhibits.

The panel also discussed the US Supreme Court's[12] recent rejection of the "substantial competitive harm" prong of the definition of "confidential" under Exemption 4 to the Freedom of Information Act, which was the standard on which the SEC's requirements for confidential treatment had been based. In response, the SEC adopted amendments to Item 601 of Regulation S-K[13] to remove the competitive harm requirement and replace it with a standard that permits information to be redacted from material contracts if it is both customarily and actually treated as private and confidential and also is not material, with corresponding changes to the legend requirement. These amendments will take effect on March 15, 2021.

Notes

1. Rutgers Center for Corporate Law and Governance et al., Report of the 2020 Multi-Stakeholder Working Group on Practices for Virtual Shareholder Meetings (Dec. 10, 2020), available at *https://cclg.rutgers.edu/wp-content/uploads/VSM-Working-Group-Report-12_10_2020.pdf*.
2. SEC Staff, Regulation S-K Compliance and Disclosure Interpretations, Question 219.05 (last updated Sept. 21, 2020), available at *https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#219.05*.
3. SEC Release No. 84429, "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements," October 16, 2018, available at *https://www.sec.gov/litigation/investreport/34-84429.pdf*.
4. SEC Press Release No. 2020-31, "SEC Charges Robinhood Financial With Misleading Customers About Revenue Sources and Failing to Satisfy Duty of Best Execution," available at *https://www.sec.gov/news/press-release/2020-321*.
5. SEC Press Release No. 2020-38, "Wells Fargo to Pay $500 Million for Misleading Investors About the Success of Its Largest Business Unit," available at *https://www.sec.gov/news/press-release/2020-38*.
6. SEC Press Release No. 2020-306, "SEC Charges The Cheesecake Factory For Misleading COVID-19 Disclosures," available at *https://www.sec.gov/news/press-release/2020-306*.
7. SEC Release No. 33-10751, "Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations," January 30, 2020, available at *https://www.sec.gov/rules/interp/2020/33-10751.pdf*.
8. SEC Release No. 33-10890, "Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information," November 19, 2020, available at *https://www.sec.gov/rules/final/2020/33-10890.pdf*.
9. "Regulatory Freeze Pending Review—Memorandum for the Heads of Executive Departments and Agencies," Ronald A. Klain, Assistant to the President and Chief of Staff, January 20, 2021, available at *https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/20/regulatory-freeze-pending-review/*.
10. SEC Release No. 33-10889, "Electronic Signatures in Regulation S-T Rule 302," November 17, 2020, available at *https://www.sec.gov/rules/final/2020/33-10889.pdf*.
11. SEC CF Disclosure Guidance: Topic No. 7, "Confidential Treatment Applications Submitted Pursuant to Rules 406 and 24b-2," December 19, 2019, amended September 9, 2020, available at *https://www.sec.gov/corpfin/confidential-treatment-applications*.
12. Food Marketing Institute v. Argus Leader Media, dba Argus Leader, 588 U.S. ___ (2019).
13. SEC Release No. 33-10884, "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," November 2, 2020, available at *https://www.sec.gov/rules/final/2020/33-10884.pdf*.

© 2021 CCH Incorporated and its affiliates. All rights reserved.

To subscribe, call 1-800-638-8437 or order online at www.WoltersKluwerLR.com

Ordering Additional Copies of INSIGHTS

Get multiple copies at a terrific discount and have the most up-to-date information available at your fingertips.

Discount Schedule

25-49	=	20%
50-99	=	30%
100-299	=	40%
300-999	=	47%

February/ 10041527-0500

Wolters Kluwer Law & Business US connects legal and business communities with timely, specialized expertise and information-enabled solutions to support productivity, accuracy and mobility. Serving customers worldwide, our products include those under the Aspen, CCH, ftwilliam, Kluwer Law International, MediRegs, and TAGData names.