Top 10 Topics for Directors in 2017: SEC Scrutiny

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a. Whistleblower Protections. 2016 saw the SEC's whistleblower program hit full stride, with multiple whistleblower awards exceeding $20 million, bringing the total amount of awards in the whistleblower program's brief history to well over $100 million. The SEC also brought several first-of-a-kind cases applying new rules flowing from the protections now afforded to whistleblowers of potential violations of the federal securities laws. In addition, the SEC brought its first "stand-alone" whistleblower retaliation case against a public issuer, in which the agency did not allege or find an underlying violation of the federal securities laws. The case involved a whistleblower report to an internal corporate hotline and the SEC's Office of the Whistleblower regarding suspected improprieties in the company's accounting practices and financial reporting. The whistleblower—previously the recipient of favorable performance reviews—was terminated within two months of his reports. The SEC's order, which contained no findings as to whether the whistleblower had a reasonable, good faith belief for his reports or whether the company had a nonretaliatory reason for terminating the employee, sends a clear message that the agency will fight to protect whistleblowers of potential violations of the federal securities laws from employment decisions that could be perceived as either retaliatory or adverse following a whistleblower action. The SEC has similarly taken a skeptical view of employment agreements that could impede an employee's ability to file whistleblower reports with the SEC. These actions reflect the granular approach that the SEC will take to ensure that there are no restrictions on terms of employment that could interfere with the strong whistleblower protections enacted by Dodd-Frank.

b. Non-GAAP Financial Disclosures. During 2016, the SEC has dramatically increased its scrutiny of non-GAAP disclosures, commencing with SEC Division of Corporation Finance comment letters to companies and, more recently, through the May 2016 issuance of 12 new and updated Compliance & Disclosure Interpretations. Subsequently, beginning in August 2016, the Division of Enforcement staff of the SEC's Philadelphia regional office sent letters to select issuers titled "Re: Certain Non-GAAP Financial Measure Disclosure Deficiencies." The letters request issuers to voluntarily provide information and documents regarding an issuer's non-GAAP disclosures. This enforcement "sweep" resembles past enforcement crackdowns in the areas of Section 13 and 16 reporting and is both in its early stages and evolving. Issuers should closely monitor all their communications, not merely their SEC filings, for compliance with the SEC's non-GAAP disclosure rules, including the May 2016 Compliance & Disclosure Interpretations.

c. Accounting controls preventing cyber-related fraud. The SEC has also been active in its review of internal accounting controls and their ability to combat modern-day threats to corporate infrastructure. Recently, with the increase of cyber fraud, including so-called "business email compromise fraud," which has affected scores of issuers and led to millions of dollars of shareholder money being transferred fraudulently overseas, the SEC has begun investigating whether affected issuers had internal accounting controls designed to prevent such scams. Some of these frauds have resulted in tens of millions of dollars of losses to public issuers. The SEC's decision to apply securities law requirements regarding internal accounting controls to these fact patterns places companies in the difficult position of not only having to disclose the embarrassing loss of corporate funds, but also defending negligent employee conduct that did not stop the fraud.

d. Insider Trading. The U.S. Supreme Court's December 2016 opinion in Salman v. United States—its first opinion regarding the law on insider trading in nearly 20 years — provided federal prosecutors and the SEC with a significant victory. The Court held that gifts of material nonpublic information by tippers to friends or relatives rise to the level of "illegal insider trading" irrespective of any tangible personal benefit to the tipper. During the pendency of the Salman case, the SEC stepped up its investigatory efforts in insider trading cases, searching for expansive webs of tippers and tippees through advanced analytical tools developed in the Division of Enforcement's Market

Abuse Unit's Analysis & Detection Center. Under this "trader-based" approach to insider trading investigations, the SEC looks for patterns of trades and the tipping source through additional analytical tools that help establish connections between people. These tools digest enormous volumes of data, from credit history to brokerage records, and telephone records to emails, thereby speeding up investigations and sharpening the SEC's ability to prosecute insider trading. The evidence developed by these tools also serves as the foundation for the SEC's referral of many well-developed insider trading cases to the Department of Justice for criminal investigation. When the initial tip of material nonpublic information originates with a corporate insider, the SEC will often rely on any certifications by that corporate insider of the public issuer's compliance policies and code of ethics, which should prohibit the misuse of material nonpublic information, as evidence of the tipper's wrongful intent. The SEC's use of advanced in-house analytical tools—both human and automated—should push public issuers to redouble efforts regarding the protection of confidential information regarding all corporate activities, including scheduled periodic reports regarding financial results and unscheduled announcements of events such as mergers and acquisitions.

In addition, 2017 is expected to bring the appointment of three new SEC commissioners, including a new chairperson selected by President-elect Trump to replace outgoing chair Mary Jo White. After the completion of the Senate confirmation process, Republican appointees will hold a 3-2 advantage over Democrat appointees. The new chairperson will also appoint a new Director of Enforcement. The new commission could also seek to make significant changes to rules promulgated previously under Dodd-Frank.

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