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Tech Cos. Could Face Stiffer SEC Enforcement Under Biden

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After shifting from broken windows to retail investors in the recent past, the U.S. Securities and Exchange Commission's Division of Enforcement will likely be guided by a new mantra over the next four years under President-elect Joe Biden.

There will be a new SEC chair and senior leadership. As we look forward to the Enforcement Division's priorities in the months and years to come, Silicon Valley and tech companies will continue to draw scrutiny.

In recent years, the media, public commentators and Congress have shifted their focus away from Wall Street banks in the aftermath of the 2008 financial crisis, toward a new focus that includes technology and social media companies.

In March 2016, then-SEC Chair Mary Jo White gave a speech at Stanford University strongly reminding tech companies of their obligations to investors and capital markets.[1] The Wall Street Journal described White's address as "a warning shot at Silicon Valley."[2] The SEC has since brought significant enforcement actions against public and private tech companies.

Although many tech companies have thrived during the pandemic and delivered positive returns for their investors, the Enforcement Division will not likely show much sympathy for tech companies that find their way onto the SEC's radar.

As new SEC leadership is installed, legal departments at tech companies, and all public companies for that matter, should focus on several core areas, in particular: whistleblowers, earnings management and risk disclosures, and insider trading — all potentially impacted by the federal courts in serving as a check on SEC enforcement.

Whistleblowers

Established with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the SEC's whistleblower program has been a game changer for enforcement. In the last fiscal year ending Sept. 30, the SEC's Office of the Whistleblower oversaw record-breaking awards of more the $175 million to 39 whistleblowers.[3] This trend continues.

Changes in case law, publicity, an active and organized whistleblower bar, and remote work environments suggest that whistleblower tips will increase. The U.S. Supreme Court's 2018 decision in Digital Realty Trust Inc. v. Somers incentivizes whistleblowers to report violations to the SEC directly, and not just internally, as the court held that protections against retaliation apply only to the former.[4]

Remote work also appears to foster tips. The SEC received 23,650 tips, complaints and referrals in 2020 — a substantial increase over the 16,850 received in 2019 — and the bulk of those received in 2020 were received during the pandemic.[5] This is consistent with whistleblower counsel observations that working remotely can embolden employees and provide an environment where tipsters are more likely to report.

Finally, the SEC's strong publicity of whistleblower awards may incentivize tipsters. Since remote work began in March, the SEC has announced whistleblower awards on an almost weekly basis: 37 whistleblower awards, totaling over $326 million, including a single award of $114 million in October. This average award of almost $9 million per whistleblower serves as powerful motivation.

Given this trend, tech companies, both public and pre-initial public offering, should assess their whistleblower policies and procedures to mitigate risk. Specifically, in-house counsel should make sure internal tips are logged, investigated, and documented.

As appropriate, in-house counsel should inform the reporting employee of the company's actions. Companies should also assess employee morale and use exit interviews to identify areas of risk.

Earnings Management and Risk Disclosures

Earnings Management

We expect the SEC to continue focusing on quarter-end transactions or accounting adjustments that appear to be taken to meet financial guidance, especially those taken to perpetuate a streak of meeting or beating such guidance. Recently, the SEC has probed the use of sales incentives to meet earnings guidance, including price rebates, discounted prices, free products and extended payment terms.[6]

Studies and anecdotal evidence indicate that it is not uncommon for public companies, including tech issuers, to evaluate strategies to close the gap between actual and expected performance at quarter- or year-end.

Indeed, management is expected to provide guidance to analysts, effectively manage the company's business and create shareholder value. But whether and in what circumstances these strategies constitute improper earnings management or violate the federal securities laws is up for debate.

Since at least former Chairman Arthur Levitt's 1998 speech titled "The Numbers Game," the term "earnings management" has been considered a dirty word by regulators. Levitt identified examples of such "accounting hocus-pocus" and abuse, including premature revenue recognition, which would not be compliant with generally accepted accounting principles, or GAAP, and, if discovered and determined to be material, would constitute a misstatement.

But recent enforcement actions involving earnings management do not involve violations of GAAP or false revenue.[7] Rather, enforcement has focused on whether certain operational incentives and sales practices have resulted in a failure to disclose known trends and uncertainties that are reasonably expected to have an impact on sales, revenues or income.

Tech and other public companies should question whether engaging in operational measures that fall in the bucket of earnings management may make them the target of SEC investigation. Examples include end-of-the-quarter discounts to accelerate renewals; prioritizing deals that have upfront revenue; increasing prices at the beginning of the next quarter to encourage customers to buy this quarter; postponing an acquisition; or cutting expenses by delaying training or research or advertising.

Whether such actions are appropriate and must be disclosed for investors to have an accurate picture of a company's earnings stability or growth trajectory is a highly fact- and circumstance-specific analysis.

Additionally, it is crucial to maintain strong disclosure controls and procedures to ensure that this analysis happens in real time. To ensure their disclosure controls and procedures are effectively assessing possible earnings management, companies should affirmatively evaluate changes to their usual sales incentives and whether the current period activity has materially exceeded what they consider standard.

Risk Factor Disclosure

Under the new administration, tech companies and other Silicon Valley issuers should also expect the Enforcement Division to continue to investigate whether a company's risk factor disclosures are misleading, especially if situations are presented as hypotheticals after they already have become reality.

The SEC has brought several settled cases against high-profile issuers regarding risk disclosures, including those concerning cyber or data breaches, publicity affecting reputational risk, and government enforcement actions.[8]

At base, it is important that companies draft disclosure controls and procedures to ensure sufficient interaction between employees responsible for monitoring material events, transactions, and reports and those responsible for disclosure in public filings and elsewhere.

Companies should ensure that the left hand knows what the right hand is doing. Internal controls may include a systematic practice of sharing potentially material information with the company's outside auditors or counsel to assess disclosure obligations, with members of the financial team in charge of assessing material loss contingencies, and with individuals responsible for drafting and approving periodic reports.

Insider Trading Cases

Insider trading enforcement, in particular SEC investigations into suspicious pandemic-related trading, will make a comeback under the new administration. Although the Enforcement Division brought the lowest number of insider trading cases in decades under President Donald Trump, tech companies featured in the division's insider trading cases over the past year.

Many of these cases presented all-too-familiar fact patterns, with employees tipping family and friends regarding confidential earnings and financial performance. The SEC has also scrutinized stock buybacks in recent months.[9]

As of October, the SEC had opened over 150 pandemic-related investigations[10] and has been quick to recognize that the pandemic provides ample opportunities to trade on the basis of material nonpublic information.

The SEC's pronouncements may serve as a harbinger for future enforcement. The SEC issued several warnings regarding insider trading during the spring, including a forceful reminder of insider trading prohibitions by the division's co-directors in March.[11]

The challenges faced by tech companies in the current environment are appreciable: a vast array of employees, and not just the usual C-suite insiders, may have material nonpublic information and many of these employees are working remotely.

Corporate counsel should assess their policies to ensure that they guard against trading by all employees, regardless of rank or position, and hold periodic, mandatory trainings on these policies. In-house counsel should also consider whether other preventive measures can help their companies avoid or minimize SEC scrutiny, like blackout periods, restricted security lists, heightened preclearance procedures and reviews of employee trading.

Courts as a Check

Through the balance of powers, courts have always served as a check on SEC enforcement. This may prove especially relevant with the success of the Trump administration in appointing judges to the bench.

Having appointed roughly 24% of all active federal judges,[12] Trump and his lieutenants were candid in their strategy to nominate judges with a healthy skepticism toward a powerful administrative state,[13] and this may affect agencies in a new administration when they go to court.

Whatever the Enforcement Division prioritizes, history makes clear that the courts will have their say in shaping the SEC's agenda. For example, after the Dodd-Frank Act was passed, the SEC pursued more contested cases through administrative proceedings than it had previously,[14] only to find the Supreme Court to effectively limit the SEC's ability to do so in Lucia v. SEC.

While the SEC has tried to address Lucia in a way that might pave the way for future administrative proceedings — and away from jury trials — cases contesting the constitutionality of hearings before the SEC's administrative law judges are again winding their way through the federal courts, with the U.S. Court of Appeals for the Fifth Circuit having recently agreed to hear en banc one such case.[15]

The Supreme Court's recent decisions limiting the SEC's ability to pursue disgorgement in certain kinds of cases[16] or for violations for which statutes of limitations have expired[17] will also impact the SEC's agenda. A new administration might wish to take aggressive enforcement action or crack down on a particular industry but federal courts may reign in those aspirations.

Accordingly, companies facing the prospect of SEC enforcement actions should pay close attention to how the SEC's new agenda fares in the courts when considering their options.

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[1] Mary Jo White, Chair, U.S. Sec. and Exchg. Comm'n, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016), https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html.

[2] Dave Michaels and Telis Demos, SEC's White Warns Silicon Valley on Valuations, Wall Street Journal (Mar. 31, 2016), https://www.wsj.com/articles/secs-white-warns-silicon-valley-on-valuations-1459471580.

[3] U.S. Sec. and Exchg. Comm'n, Office of the Whistleblower, 2020 Annual Report to Congress (2020), at 9, available at https://www.sec.gov/files/2020%20Annual%20Report_0.pdf.

[4] 138 S.Ct. 767 (2018).

[5] U.S. Sec. and Exchg. Comm'n, Division of Enforcement, 2020 Annual Report (2020), at 19, available at https://www.sec.gov/files/enforcement-annual-report-2020.pdf.

[6] See, e.g., In the Matter of HP, Inc., AP File No. 3-20112 (Sept. 30, 2020), https://www.sec.gov/litigation/admin/2020/33-10868.pdf; Khadeeja Safdar, Under Armour Receives Wells Notices from SEC, Wall Street Journal (July 27, 2020), https://www.wsj.com/articles/under-armour-says-it-gets-wells-notices-from-sec-11595855250 (reporting that the SEC issued a Wells notice to Under Armour relating to the company's public disclosures around its accounting in 2015 and 2016).

[7] See In the Matter of HP, supra.

[8] See, e.g., SEC v. Facebook, Inc., No. 19-cv-04241-JD (N.D. Cal. July 24, 2019) available at https://www.sec.gov/litigation/complaints/2019/comp-pr2019-140.pdf; SEC v. SeaWorld Entertainment, Inc., No. 18-cv-08480-CM (Sept. 18, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp-pr2018-198.pdf; SEC v. Mylan N.V., No. 19-CV-02904-RDM (D.D.C. Sept. 27, 2019), available at https://www.sec.gov/litigation/complaints/2019/comp-pr2019-194.pdf.

[9] See Anna Erickson White, David M. Lynn, Haimavathi Marlier, and Jackie Liu, COVID-19 and Rule 10b5-1 Plans: Best Practices, Morrison & Foerster (Mar. 16, 2020), https://www.mofo.com/resources/insights/200316-covid-19-rule-10b5-1-plans-best-practices.html.

[10] See Jay Clayton, Chairman, U.S. Sec. and Exchg. Comm'n, An Update on FY 2020 Results – Remarks at SEC Speaks (Oct. 8, 2020), available at https://www.sec.gov/news/speech/clayton-sec-speaks-2020-10-08 ("The Division's activities during the pandemic have included ... over 150 newly opened COVID-related investigations and inquiries.").

[11] See Haimavathi Marlier and David A. Newman, Beware Intense Insider Trading Scrutiny in Current Client, Law360 (Apr. 8, 2020), https://media2.mofo.com/documents/200408-trading-scrutiny.pdf.

[12] See John Gramlich, How Trump compares with other recent presidents in appointing federal judges, Pew Research Center (July 15, 2020), https://www.pewresearch.org/fact-tank/2020/07/15/how-trump-compares-with-other-recent-presidents-in-appointing-federal-judges/.

[13] Jeremy W. Peters, Trump's New Judicial Litmus Test: Shrinking 'the Administrative State,' New York Times (Mar. 26, 2018), https://www.nytimes.com/2018/03/26/us/politics/trump-judges-courts-administrative-state.html.

[14] See Jean Eaglesham, SEC Wins With In-House Judges, Wall Street Journal (May 6, 2015), https://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[15] See Cochran v. SEC, et al., 969 F.3d 507 (5th Cir. Aug. 11, 2020), reh'g en banc granted, 2020 WL 6495394 (5th Cir. Oct. 30, 2020).

[16] See Liu v. SEC, 140 S. Ct. 1936 (2020); see also Michael D. Birnbaum, Haimavathi V. Marlier, Jina Choi, and Gerardo Gomez Galvis, How Supreme Court Ruling on Disgorgement Will Affect Advisors, ThinkAdvisor (July 2, 2020), https://www.thinkadvisor.com/2020/07/02/how-supreme-court-ruling-on-disgorgement-will-affect-advisors/.

[17] See Kokesh v. SEC, 137 S. Ct. 1635 (2017); see also Michael D. Birnbaum, Jina Choi, Jordan Eth, and Joel C. Haims, The Supreme Court Will Decide Courts' Authority to Order Disgorgement in SEC Enforcement Cases, Morrison & Foerster (Nov. 4, 2019), https://www.mofo.com/resources/insights/191104-supreme-court-disgorgement-sec-enforcement-cases.html.