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GT Insights for Public Companies

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SEC Regulation

Don’t Let the Bedbugs Bite: SEC to Publicly Release Serious Deficiencies Letters

The Division of Corporation Finance recently announced that it will begin publicly releasing on EDGAR “bedbug” letters issued on June 15, 2018 and thereafter. Bedbug letters are issued by the Staff to advise the issuer that its registration statement or other offering document is so deficient that the Staff will not review it until the filing is amended to resolve the deficiencies.

The Staff selectively reviews certain registration statements or offering documents and generally makes the review correspondence publicly available through EDGAR no sooner than 20 business days after completing a filing review. However, the Division indicated that in the case of these seriously deficient filings, it intends to release the “bedbug” letters on EDGAR within 10 calendar days of issuance. The Division noted that the public release of these letters “will make it clear that the Division believes the filing under consideration is not minimally compliant with statutory or regulatory requirements.” Furthermore, these letters “will appear in companies’ filing histories as SEC STAFF LETTER: SERIOUS DEFICIENCIES.”

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Growing Support for Eliminating Quarterly Guidance

Long the subject of debate in academic circles, in recent weeks, a number of business organizations have publicly voiced their opposition to the release of quarterly earnings guidance. Specifically, the Business Roundtable, the National Association of Corporate Directors, and the National Investor Relations Institute have all issued reports calling for the elimination of quarterly earnings guidance. The common refrain, echoed also by prominent business leaders such as Warren Buffet and Jamie Dimon, is that companies that focus on meeting short-term quarterly projections do so at the expense of long-term value creation. The result is corporate decision-making that is not in the long-term shareholders' best interests. Quarterly forecasts are becoming less popular generally, with only 108 S&P 500 companies on average issuing quarterly earnings guidance over the past five years.

SEC Commissioner Calls for Revision of Stock Buyback Rules

In a speech at the Center for American Progress, SEC Commissioner Robert J. Jackson Jr. advocated for the review and revision of SEC rules to limit executives from using stock buybacks to cash out at the expense of investors. Much of the speech focused on Rule 10b-18, which is used by public companies when conducting stock buybacks and which provides a safe harbor from securities fraud liability if the pricing and timing of buyback-related repurchases meet certain conditions. Mr. Jackson was responding, in part, to the "unprecedented wave of buybacks" following the Trump Administration's Tax Bill in December 2017.

In his speech, Commissioner Jackson expressed concern that current rules incentivize corporate executives to pursue "short-term stock-price spikes rather than long-term growth" which is contrary to the theory that paying executives in stock incentivizes them to create long-term sustainable value. Thus, according to Commissioner Jackson, the underlying theory "only works when executives are required to hold the stock over the long term."

Commissioner Jackson also stated that corporate boards and their counsel should pay closer attention to the implications of a buyback for the link between pay and performance. In particular, a company's compensation committee should be required to carefully review the degree to which the buyback will be used as a chance for executives to turn long-term performance incentives into cash. If executives will use the buyback to cash out, the committee should be required to approve that decision and disclose to investors the reasons why it is in the company's long-term interests.

SEC Enforcement

The SEC's Continued Focus on Combatting ICO Fraud

In a speech before the SEC Investor Advisory Committee on June 14th, Chairman Jay Clayton remarked on the SEC's actions on combatting Initial Coin Offering (ICO) fraud to improve the U.S. capital markets for Main Street investors. The SEC's Division of Enforcement formed a new specialized Cyber Unit which focuses on, among other areas:

- market manipulation schemes involving fraudulent information being spread through electronic and social media;
- misconduct carried out through the dark web;
- cyber-related threats to online retail brokerage accounts;
- ICOs; and

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- distributed ledger technology.

In May, the SEC's Office of Investor Education and Advocacy created a mock fraudulent ICO website, HoweyCoins.com, which serves to educate investors about what to look for before they invest in a scam. A potential investor who clicks on "Buy Coins Now" are led to investor education tools, including descriptions of the signs of fraud that are on the site.

Valerie A. Szczepanik, who has an enforcement background, was hired as Associate Director of the Division of Corporation Finance and Senior Advisor for Digital Assets and Innovation for Division Director Bill Hinman in early June. In this newly-created advisory position, Ms. Szczepanik will coordinate efforts across all SEC Divisions and Offices regarding the application of U.S. securities laws to emerging digital instruments, including cryptocurrencies, ICOs, and tokenized securities. Ms. Szczepanik most recently was an Assistant Director in the Division of Enforcement's Cyber Unit. She is also the Head of the SEC's Distributed Ledger Technology Working Group, Co-Head of its Dark Web Working Group, and a member of its FinTech Working Group.

Litigation

Delaware Court Confirms that Revenue Projections are not "Facts" and that the Lack of an Anti-Reliance Clause does not Justify Reliance on Extra-Contractual Representations about those Projections

In Edinburgh Holdings, Inc. v. Education Affiliates, Inc., et al., the Delaware Court of Chancery dismissed buyers' fraudulent inducement claim and rejected their argument that the lack of an anti-reliance clause in the parties' purchase agreement indicated an intent that buyers could rely on extra-contractual representations about the company's projected revenues.

The dispute arose in connection with the sale of an education business. The plaintiff-seller brought claims alleging that the defendant-buyers breached the purchase agreement by refusing to make an earn-out payment. The buyers asserted counterclaims and third-party claims in response, including (among other things) a claim that the seller fraudulently represented the business's future profits and that buyers were permitted to rely on those extra-contractual projections because the agreement did not include an anti-reliance clause.

The Court granted seller's motion to dismiss the fraudulent inducement claim, specifically rejecting buyers' argument that the purchase agreement's lack of an anti-reliance provision demonstrated the parties' intent that buyers could reasonably rely on extra-contractual representations. The Court further held that "buyers were not justified in relying on [the sellers] alleged extra-contractual representations regarding future performance of the business and management capabilities" in any event because: (a) projections are not "facts"; and (b) reliance on projections of future earnings is only actionable when there is proof that the sellers knew of specific facts that showed those projections "were unsound from the inception."

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