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GT Insights for Public Companies

December 19, 2016 A Bi-Weekly Update

SEC Enforcement and Litigation

U.S. Supreme Court Holds that "Gift" of Confidential Information to Friends and Family is Sufficient to Establish Personal Benefit for Insider Trading Liability

On Dec. 6, 2016, in *Salman v. United States*, the U.S. Supreme Court unanimously held that an insider's "gift" of confidential information to a "trading relative or friend" was sufficient to show personal benefit to the tipper necessary to establish a breach of fiduciary duty and insider trading liability, resolving a conflict between the Second and Ninth Circuit Courts of Appeals.

The narrow issue before the Court was whether traders who receive a "gift" of confidential information from a relative or friend who is a company insider can be held criminally liable where the tipper of the information did not receive a tangible, financial benefit in return for the tip. In *Salman*, an insider provided confidential, non-public information to his brother, expecting that his brother would trade on the information. The brother in turn shared the information with the defendant, Bassam Salman, who was his friend and the tipper's brother-in-law. Salman was convicted of conspiracy and insider trading in violation of Section 10(b) of the Exchange Act. The Ninth Circuit, parting company with the Second Circuit's recent treatment of the same issue in *Unites States v. Newman*, rejected Salman's argument that his conviction could not stand because there was no proof that his brother-in-law, the alleged tipper, received any pecuniary benefit.

At the Supreme Court, Salman argued that because the insider had made a "gift" of the information to a trading relative and consequently did not receive any pecuniary benefit from the exchange, the evidence failed to establish the personal benefit to the insider required to establish liability under *Dirks v. SEC*. Under *Dirks*, a tippee is not liable for trading on information received from an insider unless the insider "personally will benefit, directly or indirectly," from the disclosure, thus linking the insider's breach of fiduciary duty to the tippee's insider trading.

The Supreme Court, relying on *Dirks* (and partially rejecting the Second Circuit's opinion in *Newman*), upheld Salman's conviction, ruling that an inference of personal benefit is permissible where the tipper makes a gift of confidential information to a "trading relative or friend." The Court further explained that there is no requirement that the tipper also receive something of a pecuniary or similarly valuable nature in exchange for tipping a friend or relative. The Court left open the question of what degree of closeness would constitute the necessary relationship between the trader and the tipper.

https://www.supremecourt.gov/opinions/16pdf/15-628_m6ho.pdf

SEC Sanctions Demonstrate Broad Reach of Internal Controls and Books and Records Requirements

On Dec. 2, 2016, the SEC announced an agreement with a major airline to settle charges in connection with the company's reinstatement of an unprofitable flight route to curry favor with a senior public official. The SEC alleged that the company violated Sections

13(b)(2)(A) and (B) of the Securities Exchange Act of 1934, as amended. Section 13(b)(2)(A) of the Exchange Act requires issuers to make and keep books, records and accounts, that accurately and fairly reflect the transactions and dispositions of the assets of the issuer. Section 13(b)(2)(B) of the Exchange Act requires issuers to devise and maintain a system of internal accounting controls that, among other things, is sufficient to provide reasonable assurances that assets are used, and transactions are executed, only in accordance with management's general or specific authorization.

In the cease-and-desist order, the SEC alleged that the issuer's then CEO approved the new route outside of the airline's normal processes and that the route was based on the wishes of a public official, despite poor financial projections for the profitability of the route. The SEC alleged that the issuer violated Section 13(b)(2)(B) because, despite the significant potential corruption risks surrounding its dealings with public officials, the issuer failed to design and maintain a system of internal accounting controls sufficient to prevent the violation of its policies, which prohibited the use of company assets for corrupt purposes.

Additionally, the issuer's ethics code provided that employees wishing to act in ways prohibited by the ethics code could request approval for an exception. The SEC alleged that the failure to seek such an exception by prior written authorization for reinstatement of the route also caused the issuer to violate Section 13(b)(2)(A) because its books and records did not, in reasonable detail, accurately or fairly reflect the route reinstatement.

Without admitting or denying the SEC's findings, the issuer agreed to pay a $2.4 million penalty and to cease and desist from committing or causing any further violations of Sections 13(b)(2)(A) and (B) of the Exchange Act. The issuer had previously entered into a non-prosecution agreement with the U.S. Attorney's Office for the District of New Jersey and paid a $2.25 million penalty.

https://www.sec.gov/litigation/admin/2016/34-79454.pdf

SEC Regulation

Division of Corporation Finance Provides Guidance on Issues Affecting Foreign Private Issuers

On Dec. 9, 2016, the SEC Division of Corporation Finance issued Compliance and Disclosure Interpretations, or CDIs, relating to filings by foreign private issuers, or FPIs. The most significant CDIs relate to the following:

> ***FPI parent guarantors/FPI subsidiary guarantors***. If a FPI guarantees securities of a non-FPI subsidiary, or a FPI's securities are guaranteed by a non-FPI subsidiary, the FPI, the parent and the non-FPI subsidiary may use an F-series registration statement to register an offering of securities and Form 20-F with respect to any reporting obligations if they are eligible to present condensed, consolidating financial information or narrative disclosure. Issuers should look to Rule 3-10 of Regulation S-X to determine whether they are eligible to present condensed, consolidating financial information or narrative disclosure rather than separate financial statements for each of the parent and subsidiary.

> ***Deadline for Filing Form 20-F***. When the last day of the FPI's fiscal year is the last day of the month, the Form 20-F is due four complete months after that date (*i.e.*, for year-end Feb. 28, the 20-F is due June 30). When the last day of the FPI's fiscal year is a day other than the last day of the month, the 20-F is due on the same day four months ahead (*i.e.*, for year-end Feb. 15, the 20-F is due June 15).

> ***Relief for Wholly-Owned Subsidiaries***. Like with wholly-owned domestic issuers, a FPI that is a wholly-owned subsidiary that meets the requirements of General Instruction I(1)(a) and (b) to Form 10-K can omit certain information

from the Form 20-F including selected financial data, subsidiary lists, information relating to directors and senior management and compensation, and certain other information relating to the issuer.

> ***Incorporation by Reference.*** A FPI can incorporate information by reference into its Form 20-F in answer, or partial answer, to any item required to be disclosed so long as the FPI identifies with specificity the information that is being incorporated by reference.

> ***Succeeding to a FPI.*** When a non-reporting FPI succeeds to the reporting obligations of an issuer under Exchange Act Rule 12g-3, the FPIs initial filing to evidence the succession should be a Form 6-K announcing the succession, filed on EDGAR using the 8-K submission type that is appropriate to the specific transaction. Thereafter, the issuer should make all other Exchange Act filings as appropriate.

https://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm (CDIs 110.02 through 110.08)

https://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm

Division of Corporation Finance Provides Guidance on Determining Qualified Institutional Buyers Under Rule 144A

On Dec. 8, 2016, the SEC Division of Corporation Finance issued six new CDIs with respect to Rule 144A under the Securities Act of 1933, as amended. Rule 144A provides that a person complying with its provisions and participating in a distribution of securities to "qualified institutional buyers," referred to as QIBs, will not be an "underwriter" of those securities for purposes of the Securities Act. Generally, a QIB is an entity that, in the aggregate, owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity. In its newly released guidance, the SEC has provided that, when determining whether an entity is a QIB:

> securities held on margin by that entity, so long as they are not subject to a repurchase agreement, may be counted toward the $100 million threshold;

> securities loaned out by that entity may be counted toward the $100 million threshold;

> securities borrowed by that entity may not be counted toward the $100 million threshold;

> the entity's short positions in securities may not be counted toward the $100 million threshold; and

> a non-registered investment company may not aggregate its holdings with other registered or non-registered investment companies that are part of the same "family" for purposes of meeting the $100 million threshold, as such aggregation may be used only by registered investment companies.

Additionally, Rule 144A provides that an entity will be deemed a QIB if all of its equity owners are qualified institutional buyers. The SEC has now clarified that, with respect to a limited partnership, only the limited partners are considered "equity owners," eliminating the need to determine whether the general partner (unless it is also a limited partner) is a QIB.

https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (CDIs 138.05 through 138.10)

Division of Corporation Finance Provides Guidance on Regulation S

On Dec. 8, 2016, the SEC Division of Corporation Finance issued six new CDIs applicable to Regulation S under the Securities Act, which provides a registration exemption for the issuance of securities in offshore transactions to persons other than "U.S. persons." A U.S. person includes "any natural person resident in the United States." The SEC has provided

guidance that a person with permanent resident status in the United States (*i.e.,* a Green Card holder) will be presumed to be a U.S. resident. Additionally, other persons, while lacking permanent resident status, may be deemed U.S. residents. The SEC has stated that an issuer must use its own criteria to determine residency and apply that criteria without changing it to achieve a desired result. Factors that an issuer may apply include tax residency, nationality, mailing address, physical presence, the location of a significant portion of financial and legal relationships, and immigration status.

Additionally, the SEC has clarified that:

- Rule 903(b)(1)(ii) may be relied upon to issue securities into more than one country within the European Union;
- Rule 903(b)(1)(iv) may be relied upon for an offering of securities to employees if the laws, customary practices and documentation are those of the European Union (rather than of a country other than the United States);
- the SEC's guidance with respect to establishing whether offers and sales are not made to, or for the account or benefit of, a U.S. Person for purposes of Category 2 offerings may also be applied to Category 3 offerings;
- where Regulation S requires certifications and agreements, issuers and distributors may use electronic procedures to obtain the certifications and agreements, and these processes may be implemented by third parties and issuers, and distributors may rely on those procedures to the same extent and in the same manner as when certifications and agreements are obtained in paper; and
- Rule 903(b)(4) relating to guaranteed debt securities applies both in situations when the parent company is the issuer (or a co-issuer) of the debt securities and one or more subsidiaries is a guarantor, and when the parent company is a guarantor and there are one or more subsidiaries which are also guarantors of the securities, in each case as long as the payment obligation of the parent company is full and unconditional.

https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (CDIs 276.01; 277.02 through 277.06)

Accounting

SEC Provides Disclosure Guidance at the 2016 AICPA National Conference

During the recent 2016 AICPA National Conference, SEC staff, including Wesley Bricker, the newly appointed Chief Accountant, provided issuers disclosure guidance for 2017.

Non-GAAP Measures. Mr. Bricker emphasized that audit committees should understand the non-GAAP measures used by management and the controls surrounding their preparation. Meanwhile, Mr. Mark Kronforst, Chief Accountant in the SEC's Division of Corporation Finance, explained that while the SEC staff does not frequently issue comments objecting to non-GAAP adjustments related to restructuring, legal settlements, stock-based compensation expenses or the impact of purchase accounting adjustments for the step up in inventory or amortization that will only have a short-term impact, the SEC will consider the size of the adjustments and the explanations provided to ensure that the adjustments comply with the CDI guidance. Mr. Kronfrost also indicated that the SEC staff is currently conducting outreach to better understand the scope of adjustments being taken for pensions and derivatives. The SEC will generally not address these adjustments in comment letters until the outreach is completed and the SEC staff has concluded on the appropriateness of these types of adjustments. Finally Ms. Helen Munter, PCAOB Director of Registration and Inspections, stated that she expects the PCAOB to focus on non-GAAP performance measures in the upcoming year, specifically examining what incremental work auditors are doing with respect to these measures.

Segment Reporting – Nili Shah, Deputy Chief Accountant, reminded registrants that the determination of operating segments continues to be a focus of comment letters. She stated that it is important for registrants to critically examine all of the aggregation criteria for operating segments and all of the economic characteristics (quantitative, qualitative, and consistency with the overall principle), rather than only looking to the quantitative characteristics in making the determination.

Income Tax Disclosure – Ms. Shah stated that the SEC staff is concerned about a lack of improvement in the presentation of the income tax related disclosure in the financial statements and the MD&A. Specifically, the SEC staff is focused on income tax rate reconciliations, boilerplate disclosures related to changes in valuation allowances and unrecognized tax benefits, and the indefinite reinvestment assertion. She stated that unless there is improved disclosure in these areas this year, the SEC staff will likely begin issuing comments. In addition, Ms. Shah discussed the tax-related disclosures that she believes should be addressed in MD&A, including the reasons for changes in the statutory and effective tax rates (ETR), the extent to which the historical ETR is indicative of the future tax rate, the effect of taxes on liquidity, and uncertainties related to the registrant's tax positions.

https://www.sec.gov/news/speech/keynote-address-2016-aicpa-conference-working-together.html

Governance

Council of Institutional Investors warns of "Zombie" Directors on Corporate Boards

The Council of Institutional Investors, or CII, released an advisory article on "zombie" directors on corporate boards. A zombie director is a director who failed to win majority support of shareholders in an annual election, regardless of the company's vote requirement, but still remains on the board.

CII reported that, in 2016, 40 of the 44 directors at Russell 3000 companies who failed to win majority support from their shareholders are still continuing to serve as directors.

While these zombie directors are elected by legal means—via their company's plurality vote standard—in reality, this can mean that a nominee can win an election upon receiving just one favorable vote since most directors run uncontested. CII stated its belief that directors who fail to win majority support in uncontested elections should resign from the board and not be reappointed. According to CII, plurality voting results in "rubber-stamp elections and directors who are not truly accountable to shareholders."

Since 2010, CII has annually urged Russell 3000 companies that elect directors via plurality vote to adopt true majority voting.

http://www.cii.org/files/about_us/press_releases/2016/10_31_16_cii_press_release_zombie_directors_final.pdf

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