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BLOG

SEC Officials and Others Gather at 2024 Northwestern Securities Regulation Institute

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The Northwestern Pritzker School of Law hosted its 51st annual Securities Regulation Institute from January 22, 2024 to January 24, 2024 in Coronado, California. Various practitioners and professionals from the U.S. Securities and Exchange Commission (SEC), law firms, academic institutions, accounting firms and SEC reporting companies participated in the conference. Winston & Strawn LLP was a sponsor of the event. Below is a summary of key takeaways from the conference.

SELECTED UPDATES FROM SEC SENIOR STAFF

Disclosure matters:

- **The staff does not expect the SEC to issue new disclosure requirements on cybersecurity at this time but will continue to provide guidance and feedback.** SEC staff members noted that disclosure is not required at the time of a cybersecurity incident, but rather once an issuer determines that the incident is material. While the materiality of certain incidents may be readily apparent, the SEC staff understands that it may take time to determine the materiality of other incidents.
- **The SEC staff expects more specific and meaningful disclosures on interest rate and liquidity risks.**
- **The SEC staff has seen an increase in shareholder proposal no-action requests, but the topics have not changed significantly.** Recurring topics include corporate governance, environmental and discrimination issues. New topics include those related to artificial intelligence.
- **The SEC may issue guidance on artificial intelligence disclosures.** The SEC staff is paying attention to what companies are disclosing in their public filings regarding artificial intelligence, having taken notice of boilerplate language in artificial intelligence related risk factors.

Audit committee matters:

- **Audit committees should communicate frequently with the auditors and remind them of their duty to investors.** Committees should act to remind auditors that their clients are not the issuer’s management, but the investors at large.

- **Audit committees should be mindful of the best practices highlighted in PCAOB publications.** PCAOB guidance, such as questions to ask auditors, allow audit committees to better assess the quality and effectiveness of the audit.
- **Audit committees should be involved in determining the independence of the auditors and ensure that they comply with SEC rules.** Auditor independence is foundational to the credibility of an audit. Generally, the 201(b) standard of materiality applies in determining auditor independence. A reasonable investor should be able to believe that an auditor is capable of exercising an impartial and objective standard in its audits.
- **Audit committees should understand the definition and the determination of materiality in accounting errors and their impact on Internal Control over Financial Reporting (ICFR).** An accounting error is material if the error would affect the analysis of a reasonable investor, taking into account the total mix of available information. The determination of whether an accounting error is material cannot simply be a quantitative analysis. It should be a holistic one, which also includes a qualitative analysis. Also, an error being immaterial does not mean that there is no deficiency in ICFR. If there is an error, there is likely to be a deficiency in ICFR. The materiality of the deficiency in ICFR depends on the severity of the error.

Enforcement:

- **The SEC staff will scrutinize employment agreements for any impediments to whistleblowing.** The SEC staff will look at employment agreements in their totality to confirm that there are no impediments to whistleblowing. It is not sufficient for employment agreements to simply remove any explicit prohibitions on whistleblowing.
- **The SEC staff expects the Chief Security Officer (CSO) or equivalent officer to conduct reasonable due diligence on the cybersecurity of the company.** It is the actions of a CSO or equivalent officer that matters, not the position itself. It is important for whoever is performing the CSO function to conduct reasonable due diligence on the security of a company.

ESG DISCLOSURES

- **Apply the EU's Corporate Sustainability Reporting Directive (CSRD) readiness actions incrementally.** Non-EU companies, including US reporting companies, will be subject to CSRD reporting requirements if they have any of the following:
  - Securities listed on an EU-regulated market (except EU multilateral trading facilities); or
  - Annual net turnover in the EU at the consolidated or individual level of more than €150 million for the last two consecutive financial years; or
  - An EU subsidiary or branch with annual net turnover of more than €40 million in the previous financial year.

  Required reporting for non-EU companies will begin between 2026 and 2029, depending on their size and the criterion they meet. To prepare for the CSRD, companies should start from their current ESG reporting and gradually improve it to meet CSRD standards. An essential first step for companies is to conduct a double materiality assessment in order to define the scope and boundaries of their reporting requirements.
- **Perform a disclosure gap analysis and take steps to remediate.** Once companies have identified their reporting requirements, companies should seek to understand their control environment to remediate any disclosure and control gaps and redevelop disclosures to obtain assurance.
- **Assess data processes, controls and readiness to obtain assurance.** It is important for companies to continuously assess data processes, controls and readiness throughout the process of applying CSRD.
- **Be aware of anti-ESG sentiment and avoid greenwashing.** The SEC's proposed climate rules would require extensive disclosures regarding climate-related oversight, risk assessment, greenhouse gas emissions, financial statement metrics, and targets and goals. There is skepticism about the effectiveness of ESG initiatives and philosophical opposition that challenges the relationship between ESG and shareholder value. In addition,

"greenwashing," a term used to describe companies misrepresenting or misleading consumers about the direct effects of a product on the environment, a product's ingredients, the "environmental footprint" of products or business operations, a company's environmental policies and practices, eco-labeling/third-party verifications and endorsements, and being on track for net zero when no credible plan is in place, is prevalent. In fact, a majority of company executives reported that their own organizations overstate their sustainability efforts. Such practices should be avoided.

CAPITAL MARKETS UPDATE

- **Aggregate venture capital deal value experienced a downturn in 2023.** Aggregate US VC deal value in 2023 fell to $170.6 billion, which is approximately $72 billion less than aggregate US VC deal value in 2022 and nearly $175 billion less than the aggregate US VC deal value in 2021. In addition, Q4 2023 had the lowest aggregate US VC deal value since Q4 2019. Consequently, VC deals were on the whole more investor-friendly in 2023 versus 2022, with a greater percentage of overall deals in 2023 having investor-friendly terms such as cumulative dividends and liquidation preferences greater than 1x compared to 2022. In addition, companies seeking venture funding were subject to increasingly stringent due diligence requirements in 2023, as a result of both the investor-friendly dealmaking environment and the underperformance of certain venture-backed companies that raised significant amounts of capital in previous years with less scrutiny.
- **The IPO market will be active in 2024 but will also face challenges and risks.** US IPO activity in 2023 increased from 2022, showing a slow recovery going into 2024. However, both pricing activity and IPO proceeds were lower in 2023 than their peak in 2021. Factors that negatively impacted the market in 2023, including higher interest rates, market volatility, geopolitical instability and increased regulatory scrutiny, are expected to continue in 2024. The November 2024 US presidential election is also expected to shorten the IPO window and could create more uncertainty and instability in the market generally. Accordingly, companies targeting an IPO in 2024 will likely be expected to demonstrate profitability and a clear growth trajectory. They should also be prepared to accept more conservative valuations and less favorable terms, including early lock-up releases.
- **The SPAC IPO market dropped precipitously in 2023, and new SEC rules will continue to hinder activity.** While there were 613 SPAC IPOs in 2021 that raised approximately $162.6 billion in proceeds, there were only 31 SPAC IPOs in 2023 that raised approximately $3.8 billion in proceeds. New SPAC rules adopted by the SEC in January 2024 are expected to further hinder the SPAC IPO market.
- **The public company financing market was mixed in 2023, with some segments increasing and some decreasing.** Proceeds from follow-on offerings and 144A deals increased from 2022 to 2023, although they were still far below 2021 levels. Proceeds from debt issuances and PIPE deals, however, saw a decrease from 2022 to 2023.

CORPORATE GOVERNANCE AND PROXY DEVELOPMENTS

- **Shareholder activism dynamics in 2023 changed under the Universal Proxy Card rules.** The first proxy season under the Universal Proxy Card rules brought a greater focus on large cap companies, shorter dissident slates, and more activist success in getting dissident nominees on the board without as many proxy contests reaching a vote.
- **The investor focus on board oversight and director accountability continued in 2023.** Shareholder voter support of director nominees continued to decline and voter support levels for individual directors within boards grew more stratified, with directors who chair key board committees generally receiving lower voter support.
- **Say-on-pay support rebounded and scrutiny on equity plans increased in 2023.** Average support for Say-on-Pay in the S&P 500 rose to its highest level since 2020, as companies moderated executive compensation payouts to align with performance at the end of 2022. However, the percentage of equity plans submitted but not ultimately adopted increased in the first half of 2023 versus the first half of 2022.
- **There were new pressures on companies and investors due to polarized views on ESG in 2023.** Companies and investors alike grappled with competing and conflicting ESG agendas of shareholders spanning the full

ideological and political spectrum while continuing to update their disclosures on the progress and messaging of ESG priorities.

- **Shareholder proposal volume remained elevated while investor support for proposals declined in 2023.**

RE-EVALUATING COMPANY POLICIES

- **Revisit your insider trading policies to broaden the scope and specify the types of prohibited transactions.** In light of the SEC's guidance that brings gifts within the scope of insider trading, insider trading policies should be broadened to include "engaging in transactions" in company securities rather than limiting the scope to "buying" or "selling" company securities. Using such a broad definition would generally make gifts fall within the scope of insider trading. The SEC has also been using a novel theory of insider trading policy called "shadow trading," which involves Company A insiders using insider information from Company A to trade shares of Company B whose price movement is predictable given Company A's information. Studies show that shadow trading is widespread and profitable. However, it would be prudent for companies to review their insider trading policies to specify the types of prohibited transactions based on the relationship with other companies and how the information used in a trade was obtained.

- **Review your equity grant policies and consider the timing of annual equity grants and out-of-cycle grants.** Companies should review their equity grant policies and consider not making grant awards around the time when quarterly or annual filings are made. Companies should also check in with their legal counsel to confirm that there is no material non-public information that may be released around the time of an equity grant.

- **Ensure that your clawback policies comply with both SEC and DOJ requirements.** SEC clawback policies differ from those of the DOJ. Whereas the SEC clawback policies are limited to a company's officers and restatement of financials, the DOJ's guidance broadens the triggering events and the individuals to whom the policies apply.

- **Adopt perquisites policies that address the process of identifying, tracking, valuing and disclosing perquisites and the overall rationale for, and oversight of, perquisites.**

- **Manage cybersecurity risks.** Review your approach to managing cybersecurity risks and document the approach in applicable policies, procedures, committee charters and governance guidelines so that cybersecurity incidents are identified and escalated quickly to the relevant parties and that there are no unreasonable delays in reporting cybersecurity incidents to the SEC.

SHAREHOLDER ENGAGEMENT AND ACTIVISM

- **Expect operational improvement demands and CEO challenges from activists.**In 2023, activists focused their attention on operational improvements, as M&A activity remained slow. Approximately 24% of activist proposals centered around margin expansion, cost-cutting and return of capital. CEOs were aggressively targeted last year as activists pushed to hold management teams accountable for performance, M&A and strategic decisions. Shareholder support for governance proposals vastly exceeded support for environmental and social proposals in the 2023 proxy season, suggesting that shareholder support levels on ESG proposals are returning to pre-COVID levels.

- **Expectations for 2024 Activist Campaigns.** Anticipate an increase in campaign volume and politically charged themes in 2024. A rebound in M&A transactions could result in increased activist leverage and increased focus on shareholder proposals.

- **New SEC beneficial ownership reporting rules relevant to activists.** After the changes to Rule 13D, initial Schedule D filings are due within 5 business days of crossing 5% ownership, and amendments are due within 2 business days. Additionally, Item 6 specifically requires disclosure of any derivatives relating to the relevant class of securities, including settled derivatives. Proposed amendments with respect to cash-settled derivatives and groups were not adopted.

- **New SEC rules require disclosure of certain short sale positions and net short position trading activity.** On October 13, 2023, the SEC adopted new Rule 13f-2 under the Exchange Act, which requires disclosure of certain short sale positions and certain net short position trading activity on new Form SHO. If required, the disclosure is due within 14 days after the end of the applicable calendar month. Form SHO is a confidential filing (i.e., not publicly filed on EDGAR). The SEC will review the details provided in Form SHO and publish at the end of each applicable calendar month the aggregate information on large short positions related to individual equity securities and net activity during the applicable month.

ACCOUNTING AND AUDITING

- **Pay special attention to non-GAAP measures in SEC filings.** Simple technical mistakes may lead SEC reviewers to more closely scrutinize the filing.
- **Review and address CDIs in response to SEC comment letters.** It streamlines the review process, as SEC reviewers will likely request further clarification on responses that lack references to CDIs.
- **Prepare for FASB's new Segment Reporting and Income Tax Guidance.** If a public company is planning to include a non-GAAP measure for a single-segment business in an SEC filing, it should first be discussed with and reviewed by the SEC staff prior to filing publicly. Public companies with a single reportable segment must provide all ASC 280 disclosures. Public companies are also required to provide all disclosures about a reportable segment's profit or loss and assets in annual and interim periods. All entities will be required to provide more disaggregated income tax disclosures on the rate reconciliation and income taxes paid.
- **PCAOB proposal on NOCLAR would increase auditing costs.** Adopting the PCAOB proposal on noncompliance with laws and regulations (NOCLAR), a framework specifying the course of action that should be taken by auditors when they become aware of a potential illegal act, would add significant costs and delays to the audit process. Most of the comment letters indicated that the proposal was flawed.

M&A TRENDS AND DEVELOPMENTS

- **The M&A market was sluggish in 2023 but showed signs of recovery in Q4.** Worldwide M&A deal value fell by 17% in 2023 to a 10-year low. Technology deals decreased 47% compared to 2022. Healthcare deals increased 8% compared to 2022. Most of the increase in dealmaking happened in Q4 2023.
- **The carveouts in asset deals require careful attention and understanding of the transferred assets, the liabilities, and the requirements for a shareholder vote.** Different standards are used to describe "transferred assets," but the most common is "primarily used in, related or associated with the business". More than one standard may be used in one agreement. Transferability of liability is a key concern in carveout deals. Typically, the only liabilities assumed by the buyer are those that relate to the post-closing period, while the seller retains liabilities that relate to the pre-closing period (i.e., the "our watch, your watch" approach). Applying DGCL 271(a), which lacks a bright line rule, Delaware courts will conduct a highly fact-specific inquiry to determine whether a given sale constitutes "all or substantially all" of a company's assets requiring a shareholder vote based on a combination of quantitative and qualitative factors.
- **Closing conditions and representations require specific and explicit language and construction.** A minor breach can give a buyer a "walk right" if the closing condition bringdown is flat. Materiality of representations is not automatically assumed and must be codified. Best practice is for sellers is to be explicit about the rule of construction.
- **Fraud claims require careful consideration and limitation of reliance.** To minimize claims of contractual fraud, sellers should limit reliance to the four corners of a contract by using non-reliance clauses and keep in mind that courts will not uphold poor formulations of non-reliance clauses.
- **The FTC's proposed changes to HSR filings will significantly increase preparation time and expense.** If adopted, companies will be required to provide extensive narrative information about the transaction, detailed ownership and entity data, board director/observer data to flag any interlocking directorate issues, customer and supplier information, and detailed employee and labor market data.

ENFORCEMENT ACTIVITY AND INVESTIGATIONS

- **Public companies have adopted various strategies and measures to cope with increased SEC enforcements and investigations.** First, more public companies are requesting pre-reviews from the SEC.

Second, whistleblower cases lead to swifter internal investigations from companies. Third, crisis management tends to be onboarded early, usually before a crisis. Fourth, a company's culture is reviewed more holistically. Fifth, public companies are increasingly incorporating lessons learned from cases brought against other registrants (e.g., the SEC obtaining access to personal data such as text messages) and preparing accordingly.

- **The SEC has become more aggressive in bringing actions and in the scope of its settlements, but companies have also become more willing to litigate.** In recent years, some of the issuers that have challenged enforcement actions in court have received more favorable settlement terms following a favorable court ruling than the SEC might otherwise have been willing to offer during the investigatory phase.
- **Whistleblowing activity has increased in response to financial incentives.** There has been a significant (50%) increase in tips from whistleblowers from 2022 to 2023, as employees have financial incentives to report. Companies should understand that employee dynamics with respect to whistleblowing have shifted and that employees have become more prone to contacting the SEC directly and should inform the employees that any defects/flaws within the company will be quickly addressed internally.

10+ Min Read

Authors

David A. Sakowitz

Andrew Butler

John P. Niedzwiecki

Ben D. Smolij

Jacob Tabman

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David A. Sakowitz

Andrew Butler

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