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Corporate Disclosure and Enforcement Impact of COVID-19 on SEC Filings

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Introduction

John J. Carney

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John J. Harrington

- former SEC Division of Corporation Finance
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Recent SEC Statements - Enforcement

- Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity (Mar. 23, 2020)
  - "Given these unique circumstances, a greater number of people may have access to material nonpublic information than in less challenging times. Those with such access – including, for example, directors, officers, employees, and consultants and other outside professionals – should be mindful of their obligations to keep this information confidential and to comply with the prohibitions on illegal securities trading. Trading in a company's securities on the basis of inside information may violate the antifraud provisions of the federal securities laws."

Recent SEC Statements - Chair and CorpFin Director

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- SEC Chairman Jay Clayton & William Hinman, Director, Division of Corporation Finance, The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19 (Apr. 8, 2020)
  - "Company disclosures should reflect this state of affairs and outlook and, in particular, respond to investor interest in: (1) where the company stands today, operationally and financially, (2) how the company's COVID-19 response, including its efforts to protect the health and well-being of its workforce and its customers, is progressing, and (3) how its operations and financial condition may change as all our efforts to fight COVID-19 progress."
  - "We encourage companies that respond to our call for forward-looking disclosure to avail themselves of the safe-harbors for such statements **and also note that we would not expect good faith attempts to provide appropriately framed forward-looking information to be second guessed by the SEC**."
- Public Statement of SEC Chairman Jay Clayton for FSOC Open Meeting (Mar. 26, 2020)
  - "I also want any bad actor who would seek to use this challenging time to take advantage of our investors or our markets to know: the women and the men of the SEC are watching."

Recent SEC Statements - CorpFin

- CF Disclosure Guidance: Topic 9 – Coronavirus (COVID-19) (Mar. 25, 2020)
  - "[T]he effects COVID-19 has had on a company, what management expects its future impact will be, how management is responding to evolving events, and how it is planning for COVID-19-related uncertainties can be material to investment and voting decisions."
  - "We also encourage companies to provide disclosures that allow investors to evaluate the current and expected impact of COVID-19 through the eyes of management, and that companies proactively revise and update disclosures as facts and circumstances change."
  - Forward-looking information "can be undertaken in a way to avail companies of the safe harbors in Section 27A of the Securities Act and Section 21E of the Exchange Act for this information."

CF Disclosure Topic 9 (cont)

- As companies assess and disclose impacts, consider:
  - Near and long term operating and financial impact
  - Liquidity and capital resources
  - Operating status, workforce arrangements, business continuity actions
  - Significant impairments, restructuring charges, other expenses
  - Demand impacts
  - Supply chain impacts
  - Governmental actions and restrictions

CF Disclosure Topic 9 (cont)

- Non-GAAP Measures and Key Performance Indicators
  - Normal rules apply – equal prominence, clear explanation of use and calculation of COVID-related adjustments, no “cherry-picking” to present a more favorable review
  - But some flexibility – CorpFin will not object to earnings releases that reconcile non-GAAP metrics to estimated GAAP metric (or estimated range) if GAAP metric is not finalized under certain circumstances
- Cautionary note about insider trading and Regulation FD

Extended Filing Deadlines

- Order allows delay of filings due through July 1 (includes upcoming 10-Qs) up to 45 days if unable to meet deadline due to COVID-19
- Must furnish a Form 8-K by original deadline disclosing:
  - expected filing date
  - reasons for delay
  - risk factors regarding impact of pandemic

Upcoming Quarterly Disclosures

- Timing and Process
  - Should companies update the market prior to regularly scheduled earnings announcement?
  - Should companies delay their 10-Qs as permitted by the SEC extension order?
  - If companies delay 10-Qs, should they release earnings on schedule and hold typical earnings call?

Upcoming Quarterly Disclosures (cont)

- Guidance
  - Many companies have already withdrawn or will withdraw
  - Consideration of whether to replace with quantitative full-year guidance
- Status and Outlook
  - Current and forward-looking information may be more relevant than historical and quarter-end information
  - Financial condition (cash, burn rates, available, resources, covenant compliance) may be very important depending on industry
  - Operating status (are stores open, factories operating, supplies available etc.) disclosures also very important
  - May be difficult to predict future, but can disclose actions company is taking in response to pandemic
  - Challenges in striking the right balance given significant uncertainty
- Metrics
  - Routinely disclosed non-GAAP measures and KPIs may not be meaningful

Statutes and Regulations That Matter

- Item 303 of Reg S-K, 17 C.F.R. § 229.303
- Exchange Act Section 10(b), 15 U.S.C. § 78j, and Rule 10b-5, 17 C.F.R. § 240.10b-5
- Regulation FD, 17 C.F.R. Part 243
- PSLRA Safe Harbor for Forward-Looking Statements – Section 21E of the Exchange Act, 15 U.S.C. § 78u-5, and Section 27A of the Securities Act, 15 U.S.C. § 77z-2

Forward-Looking Statements

- The PSLRA defines "forward-looking statements" as, among others: (a) statements containing a projection of revenues, income, earnings per share, or other financial items; (b) a statement of the plans and objectives of management for future operations; (c) a statement of future economic performance; or (d) a statement of the assumptions underlying or relating to any of the above. 15 U.S.C. § 78u-5(i)(1), § 77z-2(i)(1)
- Forward-looking statements are protected and cannot form the basis of a fraud claim if they are "(1) identified as such, and accompanied by meaningful cautionary statements; or (2) immaterial; or (3) made without actual knowledge that the statement was false or misleading." *In re Aetna, Inc. Sec. Litig.*, 617 F.3d 272, 278-79 (3d Cir. 2010); *see* 15 U.S.C. § 78u-5(c)(1), § 77z-2(c)(1)

When Companies Say Too Much

- Walgreens (Sept. 28, 2018)
  - SEC charged Walgreens Boots Alliance Inc., former CEO, and former CFO with misleading investors about increased risk that the company would miss a key financial goal announced when Walgreen Co. entered into a merger with Alliance Boots GmbH in 2012
  - Walgreens agreed to pay $34.5 million penalty
  - “Over multiple reporting periods, senior Walgreens executives misled investors about the company’s public financial goal,” said Stephanie Avakian, Co-Director of the SEC’s Division of Enforcement
  - Specifically, Walgreens announced a two-step merger and projected that the combined entity would generate $9-9.5 billion in combined adjusted operating income in the 2016 fiscal year. After completing the first step of the merger, internal forecasts indicated that the risk of missing the 2016 projection had increased significantly, **but Walgreens and the former CEO and CFO repeatedly publicly affirmed the projections without adequately disclosing the increased risk**

When Companies Say Too Much (cont)

- Cloud Communications Company, Sonus Networks, Inc. (Aug. 7, 2018)
  - SEC charged a cloud communications company and two executives with providing misleading quarterly revenue estimates
  - **Company was aware of red flags which undermined first quarter 2015 revenue estimates, including that Sonus had pulled forward deals initially projected to close in 2015 in order to achieve its revenue guidance for the fourth quarter of 2014**
  - A week before the close of the first quarter, Sonus announced that it was lowering its revenue estimate to between $47 million and $50 million, down from the $74 million it originally announced
  - Company and executives agreed to pay over $1.9 million in penalties
  - "**The investing community expects that when companies choose to provide public financial projections, there is a reasonable basis underpinning those projections**," said Antonia Chion, former Associate Director in the SEC's Division of Enforcement. "When a company ignores red flags or takes steps to make public financial projections inaccurate we will take appropriate action."

When Companies Say Too Little

- Global Alcohol Producer, Diageo plc (Feb. 19, 2020)
  - SEC charged alcohol producer Diageo plc for **failing to make required disclosures of known trends relating to the shipments of unneeded products** by its North American subsidiary to distributors
  - Diageo failed to disclose the trends that resulted from shipping products in excess of demand, the positive impact the overshipping had on sales and profits, and the negative impact that the unnecessary increase in inventory would have on future growth
  - Diageo agreed to pay $5 million to settle the action
  - "Investors rely on public companies to make complete and accurate disclosures upon which they can base their investment decisions," said Melissa R. Hodgman, an Associate Director in the SEC's Division of Enforcement. "**Diageo pressured distributors to take more products than they needed, creating a misleading picture of the company's financial results and its ability to meet key performance indicators**."

When Companies Say Too Little (cont)

- Bank of America (Aug. 21, 2014)
  - SEC announced settlement in which **Bank of America admitted that it failed to inform investors during the financial crisis about known uncertainties to future income** from its exposure to repurchase claims on mortgage loans
  - Bank of America agreed to pay a penalty of $20 million, part of a larger global settlement
  - “Bank of America failed to make accurate and complete disclosure to investors and its illegal conduct kept investors in the dark,” said Rhea Kemble Dignam, former regional director of the SEC’s Atlanta office.
  - Bank of America admitted that it failed to disclose known uncertainties regarding potential increased costs related to mortgage loan repurchase claims stemming from more than $2 trillion in residential mortgage sales from 2004 through the first half of 2008 by the bank and certain companies it acquired
  - In connection with these sales, Bank of America made contractual representations and warranties about the underlying quality of the mortgage loans and underwriting. In the event that a loan buyer claimed a breach of a representation or warranty, the bank could be obligated to repurchase the related mortgage loan at its outstanding unpaid principal balance.

When Companies Say Too Little (cont)

- Bank of America
  - **Regulation S-K requires public companies like Bank of America to disclose in the MD&A section of its periodic financial reports any known uncertainties that it reasonably expects will have a material impact on income from continuing operations**
  - Bank of America failed to adhere to these requirements by not disclosing known uncertainties about the future costs of mortgage repurchase claims when filing its financial reports for the second and third quarters of 2009
  - These uncertainties included whether Fannie Mae, a mortgage loan purchaser from Bank of America, had changed its repurchase claim practices after being put into conservatorship, the future volume of repurchase claims from Fannie Mae and certain monoline insurance companies that provided credit enhancements on certain mortgage loan sales, and the ultimate resolution of certain claims that Bank of America had reviewed and refused to repurchase but had not been rescinded by the claimants

Insider Trading

- Former BP Employee (Apr. 17, 2014)
  - SEC charged a former 20-year employee of BP p.l.c. and a senior responder during the 2010 Deepwater Horizon oil spill with insider trading in BP securities based on confidential information about the magnitude of the disaster
  - The price of BP securities fell significantly after the April 20, 2010 explosion on the Deepwater Horizon rig, and the subsequent oil spill in the Gulf of Mexico, resulted in an extensive clean-up effort
  - BP tasked Keith A. Seilhan with coordinating BP's oil collection and clean-up operations in the Gulf of Mexico and along the coast
  - Within days, Seilhan received nonpublic information on the extent of the evolving disaster, including oil flow estimates and data on the volume of oil floating on the surface of the Gulf
  - "**Seilhan sold his family's BP securities after he received confidential information about the severity of the spill that the public didn't know**," said Daniel M. Hawke, former chief of the Division of Enforcement's Market Abuse Unit. "**Corporate insiders must not misuse the material nonpublic information they receive while responding to unique or disastrous corporate events, even where they stand to suffer losses as a consequence of those events**."

Securities Class Actions on the Horizon

- Norwegian Cruise Lines and two of its officers were sued in the U.S. District Court for the Southern District of Florida in connection with alleged misleading statements in late February indicating positive outlooks for the company, despite the coronavirus outbreak
- Florida AG has opened an investigation

Securities Class Actions on the Horizon (cont)

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- Leaked emails from Norwegian's sales managers allegedly encouraged employees to mislead customers about COVID-19 by making the following false statements, among others:
  - "The only thing you need to worry about for your cruise is do you have enough sunscreen?" one of the suggested talking points reads
  - "The Coronavirus can only survive in cold temperatures, so the Caribbean is a fantastic choice for your next cruise," one talking point reads
  - "Scientists and medical professionals have confirmed that the warm weather of the spring will be the end of the Coronavirus," reads a second
  - Another line says coronavirus "cannot live in the amazingly warm and tropical temperatures that your cruise will be sailing to"

Whistleblowers

- In FY 2019, SEC awarded approximately $60 million in whistleblower awards to 8 individuals
- SEC received over 5,200 whistleblower tips in FY 2019, the second highest number of tips received in a fiscal year and a 74% increase since the beginning of the program
- SEC received tips from individuals in 70 countries outside of the U.S., as well as from every state in the U.S.
- In FY 2019, the most common complaint categories reported by whistleblowers were Corporate Disclosures and Financials (21 percent), Offering Fraud (13 percent), and Manipulation (10 percent). SEC received nearly 300 tips (6 percent), the fourth highest allegation type, relating to cryptocurrencies

Demonstrating Good Faith

- As SEC Chairman Clayton stated, good faith attempts to provide appropriately framed forward-looking information are not expected to be second guessed by the SEC
- Good faith is defined as "[a] state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage." Black's Law Dictionary (11th ed. 2019)

Demonstrating Good Faith (cont)

- Seek advice of counsel, both in-house and external
- Follow designed policies and procedures
- Apply diligence in gathering information from around the corporation
- Be mindful of whistleblowers
- Message discipline

Q&A

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