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DISCUSSING THE TRENDS

Q&A with William R. Baker III, Alexander F. Cohen, Lawrence A. West & Joel H. Trotter

Securities and Exchange Commission: Critical Issues Facing Public Companies

April 01, 2015

Latham & Watkins partners William Baker, Alexander Cohen, Joel Trotter and Lawrence West hosted a webcast "Securities and Exchange Commission: Critical Issues Facing Public Companies." Topics discussed included the increasing collaboration between the Securities and Exchange Commission's (SEC) Division of Corporation Finance and Division of Enforcement, the SEC's evolving use of technology and analytics, disclosure issues, accounting issues in the enforcement process, regulatory initiatives and other hot button topics.

In this Q&A interview, the group offers highlights from the presentation. A recording of the full webcast is available on lw.com through October 30, 2015.

How has the SEC changed the way it uses technology and analytics in the wake of the 2008 financial crisis?

Baker: One of the most dramatic changes within the SEC generally, and the Division of Enforcement particularly, is the use of technology and data analytics. The Commission has made an enormous investment in technology and the use of data, and it starts right up front in the way that it collects information. Even in responding to enforcement requests, the SEC has very specific standards in the way that it wants material produced. The data is all going into databases at the SEC and is there for time and memorial. This is of particular interest to the SEC, not only in trading cases, but as the SEC looks for anomalies and outliers.

Beyond that, there are a number of different tools that the SEC is using. A tool that SEC Chair Mary Jo White has spoken about is called the National Exam and Analytics Tool – it enables the SEC to analyze a huge number of transactions to identify patterns, irregularities and other suspicious activities. There is also something called MIDAS, or the Market Information Data Analytics System, which is a similar way to run data analytics to examine unusual trading. And then there is something called Palantir, which the US Department of Defense uses to identify appropriate targets for drones and things like that. It is a data aggregation and visual analysis software system that also enables the SEC's enforcement division to identify possible insider trading, accounting fraud, and pump-and-dump schemes.

What impact does the SEC's requirement that companies file with eXtensible Business Reporting Language (XBRL) tagged financial statements have on enforcement?

Cohen: The requirement to use XBRL came in while I was at the SEC. The theory behind it is that there is a large amount of interesting financial data locked up in companies' paper filings, which is difficult for anybody to use on a comparative basis in that format. It is hard to mine that data and to make comparisons within industries or across industries.

XBRL changes that. While we tend to think of this as useful for analysts, it also can become important in enforcement cases because it allows you to make comparisons on specific kinds of financial metrics among companies. If you have a case that involves a question about whether or not a company's financial reporting is in line with what other companies are doing, then knowing what peers are up to may be quite important. So, although XBRL has largely been conceived of and discussed as an investor tool, it also has a very powerful potential use in the enforcement context.

What is the SEC doing about disclosure overload? Is there anything companies can do combat it?

Trotter: SEC Chair Mary Jo White discussed so-called disclosure overload in an October 2013 speech. At the time she focused on the issue of how to stop burying investors in an avalanche of information, to use the Supreme Court's phrase. She targeted disclosure overload and explained how the SEC would work to address it. One year later, disclosure "overload" became disclosure "effectiveness," the new version of this concept. In an October 2014 speech, Keith Higgins, director of the Division Finance, explained that the underlying purpose of the SEC's initiative is to make disclosure more effective. The shift from combating overload to promoting effectiveness was a bit of an admission of the inherently accretive nature of enhanced disclosure. It is hard to trim back ─ more is more. As Higgins highlighted in his speech, updating the requirements, even in the name of addressing disclosure overload, may result in more disclosure, not less.

A proposal from the New York City Bar Association suggested a one-sentence requirement that would go at the very beginning of a filing and would describe what has changed in the business and what the business is concerned about in the future. The US Chamber of Commerce also has provided some suggestions for how disclosure requirements could be dialed back to eliminate some needless disclosures that no longer make sense in an Internet-enabled world. Companies are still required, for example, to provide their historical stock price data even though anyone with a browser can in two clicks get a lot more information than you can from the quarterly stock price data in a Form 10-Q. But this is an area of focus now for the SEC — the problem of disclosure overload and proposed solutions to make disclosure more effective.

Every five years or so, a company should take a serious step back and consider having a full-blown drafting session before they file their next Form 10-K to clean up legacy disclosures. Disclosure tends to get encrusted with barnacles like the hull of a ship and you need to get it out of the water and scrape all of that stuff off. There often are quick wins for companies that focus on this issue and look for ways to streamline their disclosures.

What are the latest developments in terms of SEC whistleblower awards?

West: This is of ever increasing importance. It really begins with Dodd Frank being passed in the middle of 2010, which has the Whistleblower Award Provisions in it, also the Anti-Retaliation Provisions, which are just as important as the monetary award provisions.

In regards to the factors that allow for an increase or decrease in the size of an award, the SEC essentially won a battle against corporate interests where the corporations said they wanted the rules to require internal reporting first because corporations had developed these elaborate anonymous hotlines and very good compliance programs and felt that the SEC was undermining them with these awards. The SEC said it would not mandate internal reporting first, but would give incentives and disincentives. Anecdotal evidence is that there is not a lot of bypassing of internal mechanisms at this point.

Just to highlight a few milestones ─ the awards were extremely small for quite a while and then there was a quite a large one in 2013 of more than US$14 million. Then in 2014 the SEC awarded more than US$300,000 to an auditor/compliance person, which is an interesting point that shouldn't be missed in the whistleblower rule—that your compliance people, your lawyers and your auditors can become eligible to blow the whistle on you, which is shocking to most people. And then we see the most recent record award, which is at least US$30 million, possibly US$35 million. This certainly means that they are on the way to getting the attention of employees all over the world, and in fact this award went to a foreign national.

More Information

To find out more listen to a recording of the full webcast, available on lw.com through October 30, 2015.

Read an lw.com interview with Latham partner John Sikora titled "SEC Increases Focus on Accounting and Financial Fraud at Public Companies." Sikora joined Latham in 2014 after spending 16 years at the SEC, where he most recently was an Assistant Director in the Chicago Regional Office and the Asset Management Unit of the SEC's Enforcement Division.

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