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INSIGHT: SEC Settles with Elon Musk and Tesla: Time to Review Your Disclosure Controls and Procedures



By Matthew E. Kaplan, Peter J. Loughran and Paul M. Rodel

On September 29, the Securities and Exchange Commission announced that Elon Musk, CEO and Chairman of Tesla, Inc., had agreed to settle securities fraud charges brought by the SEC against him. The SEC charged that Mr. Musk's highly publicized August 7 tweet stating that he was considering taking Tesla private at $420 per share and that funding for the transaction had been secured, as well as subsequent tweets and disclosures, violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.

According to the SEC complaint, Mr. Musk's tweets, which contained alleged false and misleading statements and omissions of material facts, caused Tesla's stock price to jump by more than 6 percent on August 7 and led to significant market disruption. Further compounding the alleged violations, Mr. Musk made no public attempts to clarify his August 7 statements until August 13. Tesla also agreed to settle related SEC charges that it failed to have required disclosure controls and procedures covering Mr. Musk's tweets. This case provides a vivid example of the ongoing challenges of using social and other non-traditional media to make company-related disclosures and serves as a reminder for companies to review their disclosure controls and procedures to ensure that they remain up-to-date in light of new technologies. To help frame that review, we outline below the key U.S. securities law and regulatory considerations, as well as thoughts on the steps such a review should entail.

U.S. SECURITIES LAW AND REGULATORY CONSIDERATIONS

Rule 10b-5 Anti-Fraud Prohibition Rule 10b-5, the SEC's general anti-fraud rule, applies to all corporate communications. Companies and corporate insiders need to be mindful of at least two potential sources of civil and criminal liability. First, any information made available by a company or a corporate insider must be accurate in all material respects. Second, there can be no material omissions from the communication; that is, it must present all facts material to understanding the information disclosed. U.S. securities laws do not define ''materiality.'' Instead, whether information is material will depend upon whether a ''reasonable'' investor would consider the information relevant in making an investment decision. Materiality will be judged with the benefit of hindsight and if an increase or decrease in the trading price of a company's securities correlates with a particular disclosure (as was the case with Mr. Musk's tweets and Tesla's stock price), that information will likely be presumed material.

Disclosure Controls and Procedures Rule 13a-15 of the Exchange Act requires public companies to maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is in fact recorded, processed, summarized and reported as required. The SEC charged Tesla with failing to have disclosure controls or procedures in place to: (i) assess in a timely manner whether the information Mr.

Musk disseminated via Twitter was required to be disclosed in reports Tesla files under the Exchange Act and (ii) ensure that the information Mr. Musk published via Twitter was accurate and complete.

Regulation FD Regulation FD prohibits companies and corporate insiders from engaging in ''selective disclosure'' of material non-public information to certain investors or investment professionals without making the same disclosure contemporaneously and ''publicly.'' Absent adherence to relevant SEC guidance, the dissemination of investor communications via a company website or other non-traditional means of publication (e.g., Twitter) would not comply with Regulation FD. Interestingly, neither Mr. Musk nor Tesla were charged with having violated Regulation FD. That may be because the SEC determined that the use of Mr. Musk's Twitter feed to disseminate material non-public information about Tesla complied with the SEC's guidance regarding the application of Regulation FD to social and other non-traditional media.

Forward-Looking Statements Communications containing forward-looking statements pose particular liability and compliance issues. In order to obtain the benefit of the safe harbor from securities law liability afforded by the Private Securities Litigation Reform Act of 1995, a forward-looking statement must be identified as such and be accompanied by meaningful cautionary language. The confines of real-time and/or space-limited communication tools such as tweets, blog posts and other non-traditional media may make compliance with those requirements difficult.

Other Specialized Disclosure Rules In addition to complying with the general anti-fraud rules, public communications may need to comply with specialized disclosure rules. If the communication includes a non-GAAP financial measure, Regulation G would apply, and the disclosure must include a presentation of the most directly comparable GAAP measure as well as a reconciliation of the non-GAAP financial measure to its GAAP relative. Again, space-limited communications may not easily accommodate the inclusion of such required disclosure. Timing is also relevant: If the communication is made in proximity to a stockholder meeting, the communication may constitute soliciting material subject to the proxy rules. A failure to make a required filing under the proxy rules could affect a company's eligibility to use a short-form registration on Form S-3.

Stock Exchange Public Disclosure Rules Companies listed on a stock exchange must comply with the exchange's rules regarding the disclosure of certain types of potentially market-moving information, including rules requiring prior notification to the exchange and the method of public dissemination. For example, Tesla is listed on Nasdaq, which requires listed companies to notify the exchange at least 10 minutes prior to publicly releasing material information about corporate events such as a proposed going-private action. Neither Mr. Musk nor Tesla notified Nasdaq prior to publication of the August 7 tweets.

THREE STEPS FOR REVIEWING DISCLOSURE POLICIES AND PROCEDURES In light of last week's developments, we suggest that companies take the following three steps to ensure that their disclosure controls and procedures are current and comprehensive:

- **Ensure that all relevant policies have been adapted to include and clearly address the appropriate use of social and other non-traditional media.** That review should include a company's policies covering Regulation FD, corporate communications and insider trading. Companies operating in regulated industries should also consider other applicable regulatory mandates. For example, investment advisers should review their policies in light of the Investment Advisers Act testimonial rule and relevant SEC guidance.
- **Review, test and remediate disclosure controls and procedures.** Company personnel responsible for SEC reporting (such as a Disclosure Committee) need to work closely with company officials authorized to interface with the investing public. If company personnel plan to use social media or other non-traditional means to make company-related disclosures to investors, the same principles should apply that are used for press releases and other traditional disclosure, i.e, pre-review of disclosure for accuracy and tracking and evaluation of disclosure for inclusion in the company's Exchange Act reports.
- **Provide comprehensive and regular training to all relevant personnel.** Regular training is an established element of creating a ''culture of compliance'', and companies need to apply the same principle to the use of social and other non-traditional media.

Matthew E. Kaplan is Deputy Chair of the firm's Corporate Department, Co-Head of the firm's Capital Markets Group and a member of the firm's Private Equity and Banking Groups. He regularly represents issuers, private equity firms, and underwriters in public and private offerings of debt and equity securities, and he also counsels public and private companies on disclosure, corporate governance, finance and general corporate matters.

Peter J. Loughran is a corporate partner and member of the firm's Capital Markets and Private Equity Groups. He concentrates his practice in securities law and capital markets transactions and regularly represents issuers and underwriters in U.S. and international securities offerings. He also advises on a broad range of corporate governance matters.

Paul M. Rodel is a corporate partner and a member of Debevoise's Capital Markets, Banking, Private Equity and Latin America Groups. He represents U.S., Latin American and European companies in the financial services, energy, banking and media industries in registered, private and offshore capital markets transactions.