SEC staff shares plans to improve disclosure effectiveness

The Securities and Exchange Commission (SEC) staff has begun reviewing SEC disclosure requirements and reaching out to companies, investors and other market participants for ideas about how to streamline disclosures and make them more meaningful. SEC Chair Mary Jo White has indicated that this project is a priority and has directed the SEC staff to undertake a comprehensive review of the existing disclosure requirements and make specific recommendations. The SEC is expected to issue one or more concept releases later this year to seek public input.

The starting point for this initiative was the SEC staff’s Report on Review of Disclosure Requirements in Regulation S-K, which was required by the Jumpstart Our Business Startups Act (JOBS Act). In a recent speech, SEC Division of Corporation Finance Director Keith Higgins said the staff is reviewing the requirements of Regulations S-K and S-X to identify ways to reduce the costs and burdens on companies while still providing material information to investors. Reducing the volume of disclosures is not the SEC staff’s sole objective. Accordingly, if the SEC staff identifies potential gaps in disclosure or opportunities to increase the transparency of disclosures, it may recommend new or enhanced disclosure requirements.

The staff’s review includes:

- Regulation S-K – The SEC staff will review common business and financial disclosure requirements for periodic filings in Regulation S-K, as well as industry guides and form instructions (e.g., Forms 10-K, 10-Q, 8-K). The staff will consider recommending, among other things:
  - Eliminating potentially outdated disclosures (e.g., ratio of earnings to fixed charges)
 Scaling the disclosure requirements for certain categories of issuers (e.g., smaller reporting companies, emerging growth companies)

 Establishing a more principles-based approach for certain disclosures

 Reducing redundancies with disclosures already required by US GAAP

 **Regulation S-X** – The SEC staff’s review will include:

 - Considering how investors use financial statements or financial information required for entities other than the registrant (e.g., acquired businesses, equity method investees, subsidiary issuers, guarantors)
 - Looking at differences between disclosure requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 and possibly aligning certain requirements
 - Working with the Financial Accounting Standards Board (FASB) to explore and address overlapping requirements in US GAAP and SEC rules

 **Information delivery** – The SEC staff will consider how technology can be used to improve the focus and navigability of disclosures (e.g., use of structured data, hyperlinks, topical indexes for ease of navigation). The staff also will consider whether to recommend a “company disclosure” or “core disclosure” system. Under this approach, certain information that does not change frequently, such as the description of the business and certain other company information, could be disclosed in a “core” document and then supplemented by periodic and current reports.

 The staff is encouraging companies, investors and other market participants to provide their views on how to make disclosures more effective. Preparers, investors and other constituents can submit their suggestions through the spotlight page on the SEC’s website. The staff will use this page to communicate information about future public roundtables and other news about the project.

 **Improving the focus and navigability of disclosure documents**

 At the same time, the SEC staff is encouraging companies to improve their own disclosures by eliminating repetitive and outdated information and focusing on information that is material to investors. Companies should consider ways to cross-reference disclosures rather than repeat them within the filing. For example, disclosures related to legal proceedings are often repeated elsewhere in the filing, such as in risk factors, management’s discussion and analysis (MD&A) and the notes to the financial statements.

 Significant overlap often exists between the disclosure of critical accounting estimates in MD&A and the significant accounting policy footnote in the financial statements. The staff has suggested that companies should consider focusing their critical accounting estimates discussion in MD&A on management’s judgments involved in making such estimates and the variability that is reasonably likely to occur.

 **SEC rulemaking and implementation**

 **SEC rulemaking priorities**

 The SEC staff has said that certain proposals required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) are in the works, including (1) enhanced disclosure about executive pay for performance, (2) disclosures about hedging by employees and directors and (3) listing standards requiring “clawback” of executive incentive-based...

 “Our disclosure effectiveness project is intended to make sure that investors are being well-served by the disclosures they receive.”

 - SEC Chair Mary Jo White
compensation following an accounting restatement due to material noncompliance with federal securities laws. These and other rulemakings mandated by the Dodd-Frank Act and the JOBS Act are on the SEC’s 2014 rulemaking agenda, and Chair White has said they are a primary focus.

The others include:

- Reproposed rules on disclosures about resource extraction payments
- Final rules on pay ratio disclosures
- Final rules on crowdfunding and Regulation A+ exemptions
- Final rules on risk retention by sponsors of asset-backed securities
- Final rules on money market fund reform

Chair White signals that IFRS is on the SEC’s active agenda

SEC Chair White said in a recent speech to the Financial Accounting Foundation (FAF) Trustees that she hopes the SEC will address “in the relatively near future” the question of whether and, if so, how and when to further incorporate IFRS into the US financial reporting system.

Ms. White said that, while the focus during her first year as SEC Chair was on rulemaking required by the Dodd-Frank Act and the JOBS Act, “considering whether to further incorporate IFRS into the US financial reporting system also has been a priority for me.” She noted that the SEC has permitted foreign private issuers to report under IFRS without reconciling to US GAAP since 2007, and the SEC staff issued a final report on its study of IFRS in 2012. She also reiterated the views of prior SEC chairs that (1) the FASB would remain the ultimate standard setter for US companies, (2) the SEC would be focused on the interests of US investors and (3) the role of the US in the development of global standards would be an important consideration.

Registrants make first conflict minerals filings as litigation continues

Initial Form SD filings

Approximately 1,300 registrants have filed a Form SD with their conflict minerals disclosures. The number of filers is significantly lower than the 6,000 companies the SEC estimated would be affected when it adopted the rule. About 77% of the filings included a conflict minerals report (CMR), and only four CMRs were accompanied by an independent private sector audit report. Most filers stated that they were unable to determine the origin of conflict minerals in their products and filed a CMR stating the need for further due diligence, as they are allowed during the transition period.

Although the SEC staff said that registrants didn’t have to describe their products as “DRC conflict undeterminable” or “not found to be ‘DRC conflict free’” in their CMRs after a federal appeals court struck down that requirement, many registrants chose to include such language in their CMRs.

Ongoing litigation

After a three-judge panel of the US Court of Appeals for the District of Columbia Circuit decided that the requirement for issuers to disclose the conflict status of their products violates the First Amendment, the SEC issued an order staying the effective date for disclosing the conflict status. The SEC has asked the full US Court of Appeals to rehear the decision of its three-judge panel after the full Court issues a decision in a case involving a similar First Amendment issue, American Meat Institute v. United States Department of Agriculture.
Other SEC activities

2014 XBRL taxonomy

The SEC approved the use of the 2014 US GAAP XBRL Taxonomy and updated EDGAR to support it. The 2014 taxonomy adds tags for accounting standards updates, eliminates industry views and makes other changes. The 2012 version of the taxonomy is now unavailable for use, and companies that have been using it will need to use a newer version in their next periodic reports. Companies that use the 2013 taxonomy are not required to start using the 2014 taxonomy, but the SEC staff strongly encourages registrants to adopt the latest version of the US GAAP taxonomy.

Investor advisory committee approves crowdfunding recommendations

The Investor Advisory Committee (the Committee), which was established by the Dodd-Frank Act to advise the SEC on regulatory priorities and initiatives to protect investors and promote investor confidence, recently approved recommendations that the SEC include additional investor protections in its final crowdfunding rules.

The recommendations would further limit the maximum amount an investor can invest in a crowdfunding offering and require intermediaries to develop tools to ensure that investment limits are not exceeded and to monitor issuers’ compliance with SEC rules.

The Committee will meet again on 10 July 2014 to discuss the definition of an accredited investor. At the meeting, the SEC staff will brief the Committee on securities market structure and a new Market Structure Advisory Committee the SEC formed to review SEC initiatives and proposals.

Registrants provide enhanced governance disclosures

Many registrants are voluntarily highlighting governance practices in their proxy statements and improving the readability of proxy statement disclosures by using graphics (e.g., visual representations of information known as infographics, charts, tables). These new approaches can make proxy statement disclosures more understandable.

Our review of trends in proxy statement disclosures found more companies discussing company-shareholder engagement, board diversity and evaluations, and specific pay practices as part of their discussion of executive compensation.

In her recent speech to the FAF Trustees, Chair White said that she has asked the SEC staff to look at whether improvements can be made in the audit committee report included in proxy statements. She noted that the requirements have not changed significantly in a number of years.

SEC orders pilot program for increased tick sizes

The SEC ordered the national securities exchanges and the Financial Industry Regulatory Authority (FINRA) to implement a 12-month pilot program to increase the tick sizes of certain registrants. Registrants included in the program must have:

- Market capitalizations of $5 billion or less
- Average daily trading volumes of one million shares or less
- Share prices of $2 per share or more
Tick sizes are the increments in which registrants’ shares are quoted and traded. Currently, this increment is one cent. The pilot will consist of one control group that will be quoted at the current tick size increment of one cent and multiple test groups with wider tick sizes for quotes and trading (e.g., five cent minimum increments). The results of the pilot will be used to analyze, among other things, the effects of wider trading increments on liquidity, execution quality, volatility and market maker profitability.

This program is being introduced almost two years after the SEC staff issued its Report to Congress on Decimalization, which was required by the JOBS Act. In the report, the SEC staff recommended that the Commission seek additional input about how to study the effect on trading and liquidity for small and mid-cap companies and how to conduct a pilot program for increased tick sizes. The feedback about a pilot program has been mixed. The SEC’s Advisory Committee on Small and Emerging Companies recommended that smaller registrants should be permitted to elect increased tick sizes and generally supported the launch of a pilot program. However, the SEC’s Investor Advisory Committee advised the SEC not to order such a pilot program.

The exchanges and FINRA must submit a detailed plan for the pilot by 25 August 2014.

**SEC staff issues guidance on proxy advisory firms**

The Divisions of Investment Management and Corporation Finance jointly issued Staff Legal Bulletin No. 20 providing guidance on investment advisers’ responsibilities when voting client proxies and retaining proxy advisory firms. The bulletin contains the following interpretations:

- An investment adviser and its client have flexibility in determining the scope of the investment adviser’s obligation to exercise proxy voting authority and there may be certain proxy voting arrangements in which the adviser would not assume all of the proxy voting authority. For example, investment advisers and clients may agree to proxy voting arrangements in which the adviser votes all or some of the equity securities, always votes in favor of management or a particular shareholder proponent, abstains from voting any proxies at all, or votes only on particular types of proposals.

- An investment adviser may demonstrate that proxy votes are cast in accordance with its proxy voting procedures and the best interests of the client by periodically sampling compliance. At least annually, the investment adviser also should review the adequacy of its policies and procedures to determine that they have been implemented effectively.

- Investment advisers that retain a proxy advisory firm should assess the firm’s capacity and competency to analyze proxy issues, including the adequacy and quality of the firm’s staffing and personnel, its ability to ensure that proxy voting recommendations are based on materially accurate information and its ability to identify and address conflicts of interest.

- Investment advisers must adopt and implement policies and procedures to oversee proxy advisory firms. For example, investment advisers should establish and implement measures to identify and address any conflicts of interest that arise at proxy advisory firms after their initial assessments.

- When an investment adviser becomes aware that a proxy advisory firm’s recommendation was based on a material factual error, the investment adviser should investigate the error and determine whether the proxy advisory firm is taking reasonable steps to avoid similar errors in the future.
The bulletin also states that a proxy advisory firm would not qualify for the Exchange Act Rule 14a-2(b)(1) exemption from federal proxy rules if its client grants the firm authority to vote on its behalf in advance of receipt of the proxy materials for a particular shareholders’ meeting, even if that authority is revocable by the client or subject to general guidelines or policies. Also, to be exempt from federal proxy rules under Exchange Act Rule 14a-2(b)(3), a proxy advisory firm has an affirmative duty to disclose to its client any significant relationship with the company, any of its affiliates, or a known security holder proponent as well as any material interest in the matter that is the subject of the voting recommendation. The bulletin interprets “significant” or “material” to mean that the client’s knowledge would reasonably be expected to affect its assessment of the reliability and objectivity of the adviser and the advice.

The staff noted that investment advisers and proxy advisory firms may need to make changes to systems and processes based on the bulletin. The staff said it expects any such changes should be made promptly and before the 2015 proxy season.

**Current practice matters**

**Begin preparing disclosures for the new revenue standard**

Now that the FASB and the International Accounting Standards Board (IASB) have issued their joint revenue recognition standard (effective for fiscal years beginning after 15 December 2016 for public entities), registrants will need to provide disclosures in registration statements and periodic reports filed with the SEC about how they will be affected.

Staff Accounting Bulletin (SAB) Topic 11.M requires disclosure of the potential effects of recently issued accounting standards, to the extent the effects are known. Under this requirement, companies should consider making the following disclosures:

- A brief description of the standard, the date adoption is required and, for registrants applying IFRS, the date that the registrant plans to adopt, if earlier
- A discussion of the methods of adoption allowed by the standard and the method the registrant expects to use, if determined
- A discussion of the effect the standard is expected to have on the financial statements or, if the effect isn’t known or reasonably estimable, a statement to that effect
- Disclosure of other significant matters that the registrant believes might result from adopting the standard (e.g., planned or intended changes in business practices)

Initially, we anticipate companies may not know or be able to make a reasonable estimate of the effect the new standard will have on their financial statements and will make a statement to that effect. As a reminder, the SEC staff expects a registrant’s disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available. The SEC staff has indicated it expects registrants to disclose the transition method they plan to employ once they have selected it.

Companies can choose to apply the standard using either the full retrospective approach or a modified retrospective approach. Under the modified approach, financial statements will be prepared for the year of adoption using the new standard, but prior periods won’t be adjusted. Instead, companies will recognize a cumulative catch-up adjustment to the opening balance of retained earnings at the effective date for contracts that still require performance by the company and disclose all line items in the year of adoption as if they were prepared under today’s revenue guidance.
Generally, when a company adopts a new accounting standard with retrospective application, the SEC staff requires registrants to apply that standard to all periods in the five-year selected financial data table. The SEC staff has been asked and currently is considering whether it will require registrants that plan to adopt the standard on a full retrospective basis to recast all years in their five-year selected financial data table or just the years included in the audited financial statements. A registrant’s decision about whether to adopt the standard on a full retrospective basis may be influenced by the SEC staff’s decision on this matter.

**Presenting dividends per share on the annual income statement**

In practice, registrants sometimes disclose dividends per common share on the face of the annual consolidated statements of operations. In response to recent questions about the appropriateness of this presentation, the SEC staff has said that it will not object if registrants present dividends per share on the face of annual statements of operations. In addition, dividends per common share are required to be presented on the face of interim income statements under Article 10 of Regulation S-X and on the annual statement of shareholders’ equity under Rule 3-04 of Regulation S-X.

**Disclosures about insignificant investees**

A registrant must present summarized financial information under Rule 4-08(g) of Regulation S-X in its annual financial statement footnotes for all equity method investees when significance under any of the three tests in Regulation S-X, individually or in the aggregate, exceeds 10% (20% for smaller reporting companies). However, when separate financial statements of a significant equity method investee are provided to satisfy Rule 3-09 of Regulation S-X at the same time the registrant’s audited annual financial statements are filed, SAB Topic 6K.4.b states that the summarized financial information for that investee may be excluded from the 4-08(g) disclosure. In such a circumstance, the 4-08(g) disclosure would generally be included for all remaining investees.

When separate financial statements of a significant equity method investee are filed at the same time as a registrant’s Form 10-K, aggregate significance of all remaining equity method investees does not exceed 10% (e.g., remaining significance is 6%) and the registrant considers summarized financial information for remaining investees to be immaterial, the SEC staff said it would not object to the omission of the Rule 4-08(g) disclosure in its entirety.

**Personnel changes**

**Chief Accountant to leave SEC**

Chief Accountant Paul Beswick announced his plans to leave the SEC to return to the private sector after a transitional period. Mr. Beswick joined the SEC staff in 2007 as senior adviser to former SEC Chief Accountant Conrad W. Hewitt and has served as the agency’s chief accountant since 2012. During his tenure, Mr. Beswick also served as deputy chief accountant in both the accounting and professional practice groups within the Office of the Chief Accountant. He also served as staff director for the SEC staff’s work plan for the consideration of incorporating IFRS into the US financial reporting system. Before joining the SEC staff, Mr. Beswick was a partner with Ernst & Young LLP.
Head of SEC Division of Economic and Risk Analysis leaves agency

Craig Lewis, chief economist and director of the SEC’s Division of Economic and Risk Analysis (DERA), left the SEC to return to his position as professor at Vanderbilt University. Mr. Lewis had headed DERA since May 2011 and oversaw the development of analytical tools and models, such as the Accounting Quality Model, for use in risk assessment and enforcement. He also helped develop guidance on best practices for economic analysis in support of SEC rulemaking.

Enforcement

Whistleblower awards on the rise and first anti-retaliation suit brought

The SEC recently filed its first anti-retaliation enforcement case against a company that it said took retaliatory actions that resulted in a whistleblower’s resignation. The hedge fund advisory firm settled both the retaliation violation and findings that resulted from information the whistleblower provided.

The SEC’s whistleblower program rewards individuals who provide high-quality original information that leads to an enforcement action with more than $1 million in sanctions, and rewards range from 10% to 30% of amounts collected. Eight whistleblowers have received awards since the SEC’s whistleblower program began in 2011.

In a recent speech, Chair White assured directors of registrants that the program not only motivates whistleblowers to come to the SEC with information, but it also encourages them to first report wrongdoing internally through the registrants’ available channels. Qualifying whistleblowers still can receive awards even if they first report wrongdoing internally.

What’s next at the SEC?

- We expect the Commission to proceed with rulemaking mandated by the Dodd-Frank and JOBS Acts, including finalizing rules for pay ratio disclosures, crowdfunding and Regulation A+ and proposing executive compensation rules.

- We expect the SEC staff to perform additional outreach on its disclosure effectiveness project and the Commission to issue one or more concept releases later this year.

- The SEC Investor Advisory Committee will meet on 10 July 2014.

“We ... will continue to aggressively take action whenever companies attempt to stifle, deter, or punish efforts to expose wrongful conduct.”

— SEC Chair Mary Jo White