

SEC in Focus

Quarterly summary of current SEC activities

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SEC proposes changing disclosure requirements for acquisitions and disposals of businesses

The Securities and Exchange Commission (SEC or Commission) has **proposed** changing many of its disclosure rules regarding significant businesses that registrants acquire or dispose. The proposal is intended to reduce both the burden of preparing the disclosures and the likelihood of immaterial acquisitions being deemed significant while providing investors with more meaningful disclosures.

“The proposed rules are, first and foremost, intended to ensure that investors receive the financial information necessary to understand the potential effects of significant acquisitions or dispositions,” said SEC Chairman Jay Clayton. “[The staff’s] work to eliminate unnecessary costs and burdens of the current rules – which in some cases have been significant and frustrated otherwise attractive transactions – while at the same time improving the disclosures investors receive should be applauded.”

The proposal would:

- ▶ Revise the significance tests registrants use to determine whether they need to provide financial statements of a business they acquire by incorporating the registrant’s market value into the investment test and modifying the income test to use after-tax income and to add a revenue component
- ▶ Incorporate into SEC rules the established SEC staff practices on using abbreviated financial statements in certain circumstances



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- ▶ To the Point, [SEC proposes changing disclosure requirements for acquisitions and disposals of businesses](#)

- ▶ Eliminate the requirement to provide three years of financial statements for any acquired business and allow registration statements to omit acquired business financial statements if the target has been consolidated in the audited financial statements for a full year
- ▶ Revise the significance tests and raise the threshold for Form 8-K reporting of disposals of businesses to 20% from 10% to align with the requirements for acquisitions

The proposal, among other things, would also revise the pro forma financial information requirements to require, in addition to the transaction accounting adjustments, the presentation of management adjustments to reflect synergies and other effects of transactions, including management's plans, that are reasonably estimable and reasonably expected to occur.

Comments on the proposal are due by 29 July 2019.

How we see it

The proposal would reduce the need for registrants to seek relief from the SEC staff, simplify compliance and result in more consistent financial reporting for similar transactions. However, registrants could have to exercise more judgment when making management adjustments to pro forma financial information and when considering whether abbreviated financial statements are appropriate, among other things.

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- ▶ To the Point, [SEC proposes excluding some smaller reporting companies from accelerated filer status](#)

SEC proposes excluding some smaller reporting companies from accelerated filer status

The SEC **proposed** amending the definitions of an accelerated filer and a large accelerated filer to exclude smaller reporting companies that have not yet begun to generate significant revenue.

Under the proposal, smaller reporting companies with less than \$100 million in revenue would be non-accelerated filers, meaning they would not be subject to the internal control attestation requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002 and would have extended deadlines for filing periodic reports with the SEC.

In June 2018, the SEC expanded its definition of a smaller reporting company (SRC) to include issuers that have less than \$100 million in annual revenue in their most recently completed year for which audited financial statements are available and less than \$700 million in public float as of their annual measurement date. However, the SEC didn't address the filing status of issuers that qualified as SRCs under the expanded definition. As a result, these SRCs benefitted from being able to provide scaled disclosures but they continue to be accelerated filers.

The proposal also would increase the thresholds for exiting accelerated filer status to \$60 million from \$50 million and for exiting large accelerated filer status to \$560 million from \$500 million (80% of the \$75 million accelerated filer and \$700 million large accelerated filer entrance thresholds) to make them consistent with the exit provisions in the SRC definition.

In addition, the proposal would add a revenue test to the transition thresholds as follows:

- ▶ An issuer with revenue above \$100 million that qualifies as an SRC because of the public float test (i.e., has public float of less than \$250 million) would become a non-accelerated filer if its annual revenue drops below \$100 million in its most recently completed year for which audited financial statements are available.

- ▶ An issuer that has a public float and revenue above the SRC thresholds (i.e., greater than \$250 million and \$100 million, respectively) would become a non-accelerated filer and an SRC if its public float is below \$560 million and its revenue drops below \$80 million.

Comments are due by 29 July 2019.

How we see it

Independent audits of internal control of financial reporting support capital formation and investor protection, and have had a positive effect on investor confidence and market stability. The proposal would extend the exemption from the auditor attestation requirement for internal control over financial reporting (ICFR) to a subset of small-cap companies that have not yet begun generating significant revenue, similar to a bill introduced in the Senate earlier this year.

Given that the proposal provides limited discussion of the benefits of an ICFR attestation for the population of issuers that would be exempted, feedback from investors and others through the comment process will be informative for the SEC. The proposal also would provide ongoing relief from Section 404(b) attestations for some issuers that exceed the five-year limit for emerging growth company status but have not yet achieved significant revenues.

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Under the proposal, smaller reporting companies with less than \$100 million in revenue would not be subject to the internal control attestation requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002.

Other SEC rulemaking and implementation

SEC amends its auditor independence rules for lending relationships

The SEC issued a [final rule](#) amending its auditor independence rules on lending relationships between audit firms and certain shareholders of their audit clients in an effort to focus the required analysis on identifying debtor-creditor relationships that could impair an auditor's objectivity and impartiality. The amendments eliminate aspects of the current rule that presented significant practical challenges, particularly for registered investment companies, pooled investment vehicles and their auditors.

The amendments¹:

- ▶ Focus the analysis on beneficial ownership, rather than both beneficial and record ownership, and state that financial intermediaries that hold shares as record owners and have limited authority to make or direct voting or investment decisions on behalf of the shareholders of the audit clients are not considered “beneficial owners” for purposes of the analysis
- ▶ Replace the existing 10% bright-line shareholder ownership test with a “significant influence” test that is similar to other tests in the SEC auditor independence rules and uses concepts applied in Accounting Standards Codification (Codification) 323², and add guidance to help investment funds apply the standard
- ▶ Add a “known through reasonable inquiry” provision for identifying beneficial owners of the audit client's equity securities
- ▶ For purposes of applying the loan rule to investors in an audit client that is a fund and its affiliates (including commodity pools and foreign funds), exclude from the definition of “audit client” any other funds (e.g., sister funds) that otherwise would be considered affiliates of the audit client

The rule is effective 3 October 2019.

SEC issues concept release on harmonization of securities offering exemptions

The SEC issued a **concept release** seeking comment on whether it should change the framework for securities offerings that are exempt from registration to expand investment opportunities while maintaining appropriate investor protections and promoting capital formation.

The SEC noted that the framework has changed significantly over time, and its complexity may be challenging to navigate for smaller and emerging companies that want to pursue exempt offerings. In addition, investors' ability to participate in these offerings is often restricted.

In the concept release, the SEC seeks comments to help it assess the existing framework and identify potential changes to simplify, improve and harmonize the requirements. Chairman Clayton said the SEC's goal is make sure the "framework works for investors and entrepreneurs alike no matter where they are located in the United States." The Commission also released a **staff report** on the effect of Regulation Crowdfunding on capital formation and investor protection.

Comments are due 24 September 2019.

EY resources

- ▶ To the Point, [FASB proposes incorporating certain SEC disclosure requirements into US GAAP](#)
- ▶ Comment letter, [FASB's proposal to incorporate certain SEC disclosure requirements into US GAAP](#)

FASB proposes incorporating certain SEC disclosure requirements into US GAAP

The Financial Accounting Standards Board (FASB) proposed incorporating certain interim and annual SEC disclosure requirements into US GAAP at the request of the SEC.

The SEC made the request in conjunction with a final rule it issued in 2018 that eliminated or amended certain redundant or outdated SEC disclosure requirements. The SEC referred certain of its disclosure requirements that overlap with, but require incremental information to, US GAAP to the FASB for potential incorporation into the Codification.

The FASB's proposal would add interim and annual disclosure requirements to a variety of Codification topics. Most of the amendments would apply to all entities, including those that are not public business entities (PBEs), with limited exceptions, including disclosures specific to oil and gas companies and related party transactions in certain financial statements.

How we see it

While incorporating these disclosure requirements into US GAAP would simplify compliance for most registrants, the proposal would create more work for smaller reporting companies that currently receive relief from these requirements and nonpublic companies that don't have to comply with SEC requirements.

Other SEC activities and current practice matters

Commission to hold roundtable on effects of short-termism in reporting

The SEC staff will host a **roundtable** 18 July 2019 to discuss the effect of short-termism on the US capital markets and whether the current reporting system and/or regulations should be modified to address the concerns of market participants. The roundtable will be webcast live and archived on the SEC's website.

The SEC previously issued a **request** for comment on how it might revise current requirements regarding the nature, timing and frequency of interim reporting to reduce the burden on public companies while still maintaining investor protections. As part of its request, the SEC is seeking to understand current reporting practices, including the relationship between quarterly reports that companies must file with the SEC and voluntary earnings releases they issue. While the comment period has formally closed, the SEC staff has encouraged continued submissions.

EY resources

- ▶ Comment letter, [SEC's request for comment on earnings releases and quarterly reports](#)
- ▶ To the Point, [SEC seeks input on earnings releases and quarterly reports](#)
- ▶ To the Point, [Renewed focus on quarterly reporting](#)

Chairman Clayton said, “The SEC staff roundtable will seek to explore the causes of short-termism and to facilitate conversations on what market-based initiatives and regulatory changes could foster a longer-term performance perspective in American companies.”

How we see it

In our comment letter, we recommended that the Commission expand its outreach efforts beyond evaluating written comments due to the potentially far-reaching implications of changing a fundamental reporting process. We look forward to contributing to the roundtable panel discussions.

SEC staff updates Financial Reporting Manual

The SEC staff in the Division of Corporation Finance updated its [Financial Reporting Manual](#) (FRM) to:

- ▶ Remove guidance related to the impact of adopting new accounting standards on the presentation of selected financial data
- ▶ Clarify the application of Rule 3-13, including (1) the use of the Rule 3-13 waiver process for requests to omit financial statements and (2) that the staff may require other financial statements of any entity whose financial statements are either required or otherwise necessary for the protection of investors
- ▶ Update FRM references to conform to the updated revenue threshold for an emerging growth company (EGC) of total annual gross revenues of less than \$1.07 billion during its most recently completed fiscal year
- ▶ Make other technical amendments to consolidate certain information and update certain Codification references

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In 2018, SPAC IPOs
accounted for 21%
of total IPO capital
raised.

EY resources

- ▶ Technical Line, [Navigating the requirements for merging with a special purpose acquisition company](#)

SEC rejects NYSE proposal to relax listing requirements for special purpose acquisition companies

The SEC **rejected** a proposal by the New York Stock Exchange (NYSE) to reduce the minimum number of public shareholders required for public listing to 100 from 300 and to enable the NYSE to give a special purpose acquisition company (SPAC) a reasonable time period following a business combination to demonstrate compliance with certain listing standards. In its order, the SEC stated that it didn't have sufficient information to determine whether the proposed rule change was consistent with the NYSE's obligations under the Securities Exchange Act of 1934.

A SPAC is a blank-check company that raises capital from investors in an initial public offering (IPO) to use in the future to acquire a target that has not been identified at the time of the IPO. US-listed SPAC IPOs raised more than \$14 billion in 2018, up from just over \$10 billion in 2017 and four times as much as the \$3.5 billion raised in 2016. In 2018, US-listed SPAC IPOs accounted for approximately 21% of total IPO capital raised, roughly the same as in 2017, but up from 14% in 2016.

How we see it

SPACs have become popular in recent years due to volatility in the IPO market and increasing interest from financial sponsors and management teams with experience in private equity. We expect them to continue to be popular investment vehicles under current national exchange rules.

Personnel changes

Allison Lee sworn in as an SEC Commissioner

Allison Lee was sworn into office as an SEC Commissioner for a term expiring on 5 June 2022. She fills the vacant seat previously held by Kara Stein. Ms. Lee served on the SEC staff from 2005 to 2018, including serving in the Division of Enforcement and as counsel to former Commissioner Stein.



Allison Lee³

Sagar Teotia named SEC Chief Accountant

The SEC named Sagar Teotia as its Chief Accountant. Mr. Teotia had served as Deputy Chief Accountant from 2017 until last month, when he became Acting Chief Accountant. Mr. Teotia was previously a partner in Deloitte's national office after having served as a professional accounting fellow at the SEC from 2009 to 2011. As Chief Accountant, Mr. Teotia will be the principal adviser to the Commission on accounting and auditing matters.

Mr. Teotia replaces Wesley R. Bricker, who left the agency in June. Mr. Bricker had been Chief Accountant since 2016.

Enforcement activities

Truckload freight company charged with accounting fraud

A truckload freight transportation provider has been charged with accounting fraud for alleged non-disclosure of at least \$20 million in losses.

According to the complaint, the company avoided recognizing impairment charges that would have been equated to almost two-thirds of its 2016 pretax income by selling and buying hundreds of used trucks at inflated prices from third parties and lying to its auditors to conceal the scheme. The effects of these transactions materially overstated earnings reported in multiple SEC filings, the SEC said.

The company has admitted the fraud charges and related reporting, books and records, and internal control violations. It has agreed to a permanent injunction, to pay \$7 million in fines and to remediate the material weaknesses in its internal controls over financial reporting.

Supplier to smartphone manufacturer charged with accounting fraud

A supplier to smartphone manufacturers and its chief executive officer (CEO) have been charged with fraud for misleading investors about the company's ability to fulfill a contract highly material to its revenue, liabilities and stock value.

According to the order, a customer had advanced \$578 million to the company under a commercial agreement in exchange for components that were required to meet certain technical specifications. The company's failure to meet the required standards gave the customer the right to accelerated repayment of half of the funds it had advanced. The company improperly avoided recognizing this debt as current in its financial statements, and the CEO made false statements in earnings calls related to the actions of the customer, performance targets and sales projections.

Without admitting or denying the findings, the company and the CEO consented to SEC orders for antifraud violations. They also each agreed to cease and desist from further violations, and the CEO agreed to a \$140,000 fine.

SEC charges issuer with conducting \$100 million unregistered initial coin offering

The SEC filed a civil suit in federal court alleging that an online messaging provider conducted an illegal offering of digital tokens to the public. The company raised more than \$55 million from US investors through the sale of discounted tokens in the initial coin offering (ICO).

According to the complaint, the company's online messaging business was losing money, and the company sought to pivot to a new business model using the funds raised from the sale of the tokens. The complaint also alleges that the tokens were marketed by the company as an investment opportunity, and that the company misled investors about the demand for the tokens and their functionality.

The SEC complaint seeks a permanent injunction, disgorgement plus interest, and a penalty.

What's next at the SEC?

In the second half of 2019, we expect the SEC to finalize rules to streamline disclosure requirements for certain registered debt offerings, among other things. Other disclosure effectiveness proposals, including proposals to simplify business, legal and risk factor disclosures, remain on the agenda.

Chair Clayton has also said that he wants the agency to prioritize rulemaking to improve the proxy voting process, which is known as proxy plumbing.

Endnotes:

- ¹ Rule 2-01(c)(1)(ii)(A) of Regulation S-X.
- ² ASC 323: Investments – Equity Method and Joint Ventures
- ³ Photo: LinkedIn.