Issue 3, 9 July 2020

SEC in Focus

Quarterly summary of current SEC activities

In this issue:

New disclosure requirements for business acquisitions

The Securities and Exchange Commission (SEC) adopted **final rules** that amend its requirements for registrants to provide information about significant business acquisitions and disposals.

The SEC revised two of the three significance tests registrants use to determine the required disclosures for acquisitions and disposals of businesses. The investment test was revised to compare the fair value of the purchase consideration transferred to an average aggregate worldwide market value of the registrant's voting and non-voting common equity. The income test was revised to add a revenue component to the test that compares the most recent annual revenue of the acquired business to that of the registrant. Significance is measured using the lower result of the income and revenue components. The revenue component is only used if both entities have generated material revenues during each of the past two fiscal years.

The SEC also simplified pro forma financial reporting by eliminating the prescriptive legacy criteria for making pro forma adjustments and requiring two categories of adjustments: (1) transaction accounting adjustments that reflect the accounting for the transaction under US GAAP or IFRS and (2) autonomous entity adjustments that are needed when a new registrant is being spun off from a larger entity. The SEC also gave management the option to provide a third category of adjustments in the explanatory notes to the pro forma financial information that include forward-looking information (e.g., expected synergies) that have "a reasonable basis" and are necessary for a "fair presentation."

Building a better working world

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- To the Point, ***SEC streamlines disclosure requirements for acquisitions and disposals of businesses***

How we see it

Management will have to exercise significant judgment when deciding whether to include management adjustments and supporting that it has a reasonable basis for doing so and that the adjustments are necessary for a "fair presentation."

The new rules also:

- Align the significance thresholds for business disposals with those for business acquisitions
- Align certain requirements for acquired real estate operations, including significance thresholds, with those for acquired businesses
- Eliminate requirements that registrants provide three years of audited financial statements for acquisitions that exceed 50% significance
- Formalize existing practice by allowing registrants to provide abbreviated financial statements of acquired businesses that meet certain criteria
- Allow registrants to exclude pre-acquisition financial statements of acquired businesses from their registration statements in certain cases

The rules are effective 1 January 2021, but earlier compliance is permitted.

How we see it

Registrants will be required to present financial statements and pro forma financial information for business acquisitions less frequently than in the past. The changes also should significantly decrease the cost and financial reporting burden for companies that have grown through acquisitions.

COVID-19 disclosure update

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- Technical Line, ***How to appropriately use non-GAAP measures to discuss the effects of COVID-19***
- Technical Line, ***Accounting and reporting considerations for the effects of the coronavirus outbreak***

SEC staff issues statement and guidance on COVID-19 disclosures

The SEC's Chief Accountant Sagar Teotia issued a **statement** emphasizing the continued importance of high-quality financial reporting related to the COVID-19 pandemic in anticipation of the second-quarter financial reporting cycle.

Among other things, the statement reminds companies to:

- Disclose significant judgments and estimates in a way that is understandable and useful to investors
- Consider how changes in financial reporting processes, including remote-work arrangements, affect control risk and how internal controls operate and can be tested
- Consider the need for new or enhanced internal controls in response to additional risks of material misstatement arising from changes to the business and other uncertainties

In the statement, Mr. Teotia reiterated that many companies are making significant judgments and estimates, given the uncertainties related to COVID-19, and said the SEC staff will continue to not object to well-reasoned judgments. He also reiterated the responsibilities of preparers and auditors to evaluate a company's ability to continue as a going concern.

The SEC's Division of Corporation Finance also issued Disclosure Guidance **Topic No. 9A**, which provides the views of the SEC staff on disclosures that companies should consider with respect to COVID-19. This guidance supplements the SEC staff's Disclosure Guidance Topic No. 9.

The guidance focuses on the effects of COVID-19 on companies' operations, liquidity and capital resources, and provides questions that registrants should consider when crafting their disclosures for their upcoming filings. It also provides guidance for companies that have received government assistance through the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) and for companies facing substantial doubt about their ability to continue as a going concern.

SEC urges robust forward-looking disclosure in light of COVID-19

SEC Chairman Jay Clayton and Division of Corporation Finance Director William Hinman previously issued a **statement** urging companies to provide as much information as practicable about their current operating and financial status and future plans in earnings releases and calls with analysts and investors. Messrs. Clayton and Hinman noted that fighting the COVID-19 pandemic caused a "deep contraction in vast areas of our economy" and said robust disclosures are needed to help the nation responsibly increase economic activity.

In their statement, Messrs. Clayton and Hinman focused on forward-looking disclosure, saying that, in many cases, historical information may be significantly less relevant now. They urged companies to provide robust discussion about the following topics in their earnings releases and calls with analysts and investors:

- Where the company stands today, operationally and financially
- How the company's COVID-19 response, including its efforts to protect the health and well-being of its workforce and customers, is progressing
- How its operations and financial condition may change as efforts to fight COVID-19 progress

Their statement notes that detailed discussions of current liquidity positions and expected financial resources would be particularly helpful to investors and the markets. They also noted that companies should disclose the nature, amounts and effects of governmental financial assistance that has affected or is reasonably likely to affect their financial condition or results in a material way.

Messrs. Clayton and Hinman encouraged companies to make all reasonable efforts to convey meaningful information sufficient to allow investors to see the key operational and financial considerations and challenges companies face through the eyes of management. They also encouraged companies to take advantage of the safe-harbor liability protections provided by the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) and said they do not expect the SEC to second-guess good-faith efforts to provide appropriately framed forward-looking information.

COVID-19 disclosure practice observations

Many registrants have included disclosures in their filings about the impact of the COVID-19 pandemic on their businesses, financial results and liquidity. To date, we have observed the following trends but expect the nature and volume of disclosures to evolve, given the more significant impact of the pandemic in the second quarter.

Earnings releases — Many companies withdrew or reduced their earnings guidance, either for the second quarter or the remainder of the year. Instead, many companies provided forward-looking information that was qualitative rather than quantitative. Some companies quantified the expected impact of the pandemic on their results, and some of them presented a range of possible results.

***Management's discussion and analysis (MD&A)* —** Many companies included a discussion of the effects of COVID-19 in MD&A. The discussions were generally detailed and focused on the impact of the pandemic on the business and strategic actions taken by stakeholders (e.g., customers, employees, suppliers). Many companies also discussed the effects of COVID-19 in their critical accounting estimate disclosures, noting that uncertainties related to the pandemic affected key estimates and judgments involving impairment and fair value determinations.

***Risk factors* —** Most companies included robust and detailed risk factors related to the COVID-19 pandemic in their Form 10-Q filings. An EY Center for Board Matters review of the risk factors included in Form 10-Q filings of Fortune 100 companies from 1 February through 31 May 2020 found that about 90% of filings included at least one new risk factor related to COVID-19, and 16% made COVID-19-related changes to existing risk factors.

Common COVID-19-related risk factor topics include:

- Adverse effects of the pandemic, including drops in commodity prices and impacts on customers and adjacent industries
- Disruptions to the company's operations and stock price
- Availability of key personnel necessary to conduct business operations and ability to hire and onboard new employees
- Cybersecurity, privacy and data protection, particularly with respect to potential service interruptions and interference with systems
- Liquidity, disruptions and volatility in the capital markets, including potential credit rating downgrades and the inability to access capital
- Supply chain disruptions
- The eventual return to work of company employees

***Non-GAAP measures* —** While some companies reported non-GAAP measures that they adjusted for the effects of COVID-19 on their operations, most opted instead to communicate the impacts of the pandemic in a narrative discussion or in a tabular format that quantified the impacts. For companies that used non-GAAP measures, the main categories of COVID-19-related adjustments reflected:

- The impairment of intangible assets triggered by the pandemic
- The income tax effects of the CARES Act
- Disaster pay and additional cleaning costs incurred
- Costs incurred to set up remote working functions for employees

Some registrants have included non-GAAP adjustments relating to impairments of intangible assets, income tax issues and nonrecurring costs in the past, and increased their use of these adjustments to reflect the effects of COVID-19.

***Internal control over financial reporting (ICFR)* —** Most companies' disclosures said that changes in their ICFR as a result of COVID-19 were not material. However, some expanded their disclosure to highlight that they moved to a remote working environment but said it did not have a material impact on their ICFR.

SEC staff issues COVID-19-related FAQs regarding Form S-3

The SEC staff in the Division of Corporation Finance issued **COVID-19-related FAQs** to address questions about the SEC order extending the filing deadline for registrants that cannot file their periodic reports on time due to the COVID-19 pandemic. The frequently asked questions clarify that registrants that validly rely on the order:

- Can continue to conduct takedowns using an already-effective Form S-3 shelf registration statement; however, registrants and their legal advisers will need to consider whether a post-effective amendment is needed due to a "fundamental change," whether the prospectus disclosures are accurate and complete, and, if the prospectus contains annual disclosures older than 16 months, when updated information is required because it can be furnished without unreasonable effort or expense
- Must reassess their Form S-3 eligibility upon timely filing Form 10-K, including by any extended due date
- Can file a new Form S-3 registration statement, if eligible, before the extended due date of a periodic report; however, the SEC staff will be unlikely to accelerate the effective date of a Form S-3 until all required information is filed (i.e., the order does not extend the financial statement timeliness requirements for purposes of new Securities Act filings)

Investing in companies based in emerging markets exposes investors to greater risks that disclosures could be incomplete or misleading.

Recent actions focus on risks of investing in emerging markets

A series of recent actions, including proposed rules, legislation and directives issued by President Donald Trump, address the regulatory challenges associated with investing in emerging markets, including China.

SEC and PCAOB — SEC Chairman Clayton, Public Company Accounting Oversight Board (PCAOB) Chairman William Duhnke and senior members of the SEC staff issued a **statement** addressing the risks of investing in companies that are based in or have significant operations in emerging markets. The statement said they include the risks that the companies' disclosures could be incomplete or misleading and that investors will have less recourse in emerging markets, including China, given the limits on the SEC's and PCAOB's oversight and enforcement in some jurisdictions.

The statement says it is imperative that companies based in or with significant operations in emerging markets, as well as their audit committees and auditors, fulfill their responsibilities to (1) prepare and provide high-quality, reliable financial information and other disclosures and (2) provide accurate and complete risk disclosure about the rights and remedies of US regulators and investors.

The regulators emphasized that their statement is aimed at preserving and promoting the US capital markets through full and fair disclosure but not restricting access to emerging market investments.

The SEC staff was scheduled to host a roundtable on 9 July 2020 to discuss how to continue to raise investor awareness of the risks of investing in emerging markets, including China, and explore steps that could be taken to mitigate those risks.

Nasdaq — The Nasdaq stock exchange proposed **three rules** to tighten listing standards for companies based in countries that have laws or regulations that restrict US regulators' access to information. The proposals, which are subject to approval by the SEC, would codify the exchange's authority to use its discretion to impose additional listing requirements on companies in jurisdictions such as China and Hong Kong, where the PCAOB is unable to inspect the audit work and practices of a company's auditor, or in situations where a company's auditor does not demonstrate sufficient quality controls or have the resources to adequately perform the audit.

The proposals would also set a minimum offering size or float requirement for companies that primarily operate in these markets and require that they have at least one member of senior management, a director or a third-party adviser who has experience or familiarity with certain regulatory and reporting requirements.

Trump administration — President Trump **directed** the President's Working Group on Financial Markets (PWG) to discuss the risks to US investors posed by the Chinese government's refusal to allow audit firms that are registered with the PCAOB and work on audits of companies that are based in China or have significant operations there to provide their audit workpapers to the PCAOB. The PWG was also directed to recommend actions that regulators and the executive branch may take to protect US investors. The PWG is chaired by the Secretary of the Treasury and comprises the Chairman of the Commodity Futures Trading Commission, the Chairman of the Board of Governors of the Federal Reserve Board and the Chairman of the SEC.

Congress — Bipartisan legislation was also introduced in Congress that would block foreign companies from having their shares publicly traded in the US or delist existing securities of companies whose auditors are prevented from providing their audit workpapers to the PCAOB for three consecutive years following enactment of the legislation. Companies that are already listed in the US would be required to make additional disclosures, including naming any Chinese Communist Party officials who serve on their board of directors and providing the percentage of shares held by the Chinese government. The legislation passed the Senate in May and is being considered by the House.

Other SEC rulemaking and current practice matters

SEC proposes rule to modernize fund valuation practices

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- To the Point, ***SEC proposes rule to modernize fund valuation practices***

The SEC **proposed** a rule that would create a framework for the valuation practices of registered investment companies and business development companies (collectively, funds) and clarify how fund boards can satisfy their obligation to determine fair value in good faith for purposes of the Investment Company Act of 1940. The proposed rule would, among other things:

- Require fund boards or advisers to assess and manage material valuation risks, including material conflicts of interest
- Codify the common practice of boards assigning the fair value determination to a fund's adviser, subject to certain conditions, including board oversight
- State that a market quotation would be "readily available" for purposes of the Investment Company Act of 1940 only when it is a quoted (unadjusted) price in an active market for an identical investment that the fund can access at the measurement date, which would be consistent with the definition of a Level 1 fair value input in US GAAP

The SEC also proposed rescinding certain guidance on the valuation, accounting and auditing of fund investments that is included in Accounting Series Releases Nos. 113 and 118.

Comments are due by 21 July 2020.

SEC staff clarifies new disclosure requirements for mining registrants

The SEC Division of Corporation Finance issued three compliance and disclosure interpretations (**C&DIs**) clarifying the new disclosure requirements for registrants engaged in mining operations. The C&DIs clarify that:

- A registrant engaged in mining operations must comply with the new disclosure rules beginning with the Exchange Act annual report for the first fiscal year beginning on or after 1 January 2021

- The staff will not object if a Securities Act registration statement incorporates by reference mining property disclosures prepared in accordance with the previous disclosure rules under Guide 7 from an Exchange Act annual report before annual financial statements for the first fiscal year beginning on or after 1 January 2021 are required to be included in the registration statement
- If a registration statement does not incorporate by reference mining property disclosures from an Exchange Act annual report, the registration statement must be prepared in compliance with the new rules on or after the first day of the registrant's first fiscal year beginning on or after 1 January 2021

> "We continue to focus on whether companies are fully disclosing compensation paid to their top executives and have appropriate internal controls in place to ensure that shareholders receive information to which they are entitled.
>
> — Kelly Gibson, Director, SEC Philadelphia Regional Office

Personnel changes

White House plans to nominate Clayton to serve as US Attorney for the Southern District of New York

President Trump announced his intent to nominate SEC Chairman Clayton to serve as US Attorney for the Southern District of New York. The nomination requires confirmation by the Senate, and the timing of that consideration is unclear.

Caroline Crenshaw nominated for SEC seat

President Trump nominated Caroline Crenshaw to fill the seat on the SEC vacated by Former Commissioner Robert Jackson Jr., who resigned in February. Ms. Crenshaw formerly served as counsel to Mr. Jackson and currently serves as a senior counsel at the SEC.

If Ms. Crenshaw's nomination is confirmed, she could serve until at least 2024.

Commissioner Peirce nominated for second term

President Trump nominated Commissioner Hester Peirce for a second term at the SEC. Her term expired 5 June 2020, but commissioners may serve for up to an additional 18 months after their term expires.

If Ms. Peirce's nomination is confirmed, she could serve until at least 2025.

Enforcement activities

Supreme Court upholds SEC's ability to recover fraudulent gains, with limits

The Supreme Court upheld the SEC's ability to seek disgorgement of unlawfully obtained gains from those who commit financial fraud. However, the court also limited the scope of what can be sought through disgorgement by saying that the SEC's attempted recoveries couldn't exceed a wrongdoer's net profits and that recoveries should generally be returned to investors that were victims of the fraud.

Company settles charges for failing to disclose executive perks

The SEC settled charges against an insurance company for failing to disclose certain perquisites and benefits provided to its former chief executive officer.

The order asserts that the company failed to disclose in its proxy statements from 2014 through 2018 over $5 million in perquisites and personal benefits, including personal use of corporate aircraft, helicopter trips and other personal travel, housing costs, transportation for family members, personal services, club memberships and tickets and transportation to entertainment events.

Without admitting or denying the findings in the SEC's order, the company agreed to pay a $900,000 penalty.

SEC awards record payout of nearly $50 million to whistleblower

The SEC announced an award of nearly $50 million that it said was the largest amount ever awarded to one individual under its whistleblower program. The individual provided detailed, firsthand observations of misconduct by a company, which resulted in a successful enforcement action that returned a significant amount of money to harmed investors.

The SEC has awarded over $500 million to whistleblowers since 2012. Awards are paid from an investor-protection fund financed with monetary sanctions paid by securities law violators.

Company to return money from unregistered ICO to investors

The SEC settled charges against a blockchain service company for conducting an unregistered initial coin offering (ICO) of digital asset securities.

According to the order, the company raised over $25 million through unregistered sales of its tokens, which constituted securities. Without admitting or denying the findings, the company agreed to pay disgorgement of $25 million plus interest and a penalty of $400,000.

What's next at the SEC?

The SEC continues to operate in what it calls a "full telework posture." We expect the SEC staff to continue to monitor the effects of the COVID-19 pandemic and provide guidance and other assistance to issuers and other market participants as needed. In the coming months, we expect the SEC staff to focus on the quality of issuers' COVID-19-related disclosures, including non-GAAP measures, and to issue comment letters to issuers on their filings when necessary. We also expect the SEC to work on finalizing the amendments it proposed to simplify and modernize the disclosure requirements of Regulation S-K.