Issue 4, 1 October 2020

SEC in Focus

Quarterly summary of current SEC activities

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SEC streamlines Regulation S-K disclosures

The Securities and Exchange Commission (SEC or Commission) adopted **amendments** to its rules in Regulation S-K to streamline the disclosures registrants are required to make about business, legal proceedings and risk factors and to add new requirements for disclosures about human capital resources. The amendments take a principles-based approach that gives registrants flexibility to tailor disclosures to their circumstances. They change disclosure requirements for registrants in the following areas:

Description of business **—** The amendments eliminate the requirement to disclose general business developments over the past five years and allow registrants to tailor the disclosures to contain information that is material to an understanding of the development of their business. In filings after an initial registration statement, registrants will be permitted to provide only material updates along with a hyperlink to the most recently filed full discussion of developments that, together with the update, would present a complete discussion.

The amendments provide a non-exclusive list of topics that require disclosures only if they are material to an understanding of the registrant's business taken as a whole. The SEC expanded the topic on compliance with environmental laws to include compliance with all material government regulations, and it eliminated specific references to backlogs and working capital and combined related items like products and services provided and dependence on certain customers.

The amended rules also eliminate the requirement to name any customers that account for 10% or more of revenue, but registrants will need to consider whether the name of such a customer is a material fact that needs to be disclosed.

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- To the Point, ***SEC streamlines some Regulation S-K disclosures and requires human capital disclosures***

Human capital resources — Registrants will be required to include a description of human capital resources and any measures or objectives on which management focuses, if they are material to an understanding of the business. They will also have to continue to disclose the number of people they employ.

The final rules cite measures on personnel attraction, development and retention as examples of human capital measures and objectives that may be material but do not prescribe specific measures that all registrants must disclose.

The SEC said in its adopting release that its principles-based presentation will allow the human capital disclosures to evolve over time in response to factors such as the industry and macroeconomic conditions that affect human capital resources, such as national or global health matters.

How we see it

This is the first time the SEC has mandated disclosure about a matter that is increasingly being used as a measure of long-term value created by a company. We believe this change may cause companies to consider providing disclosures about other drivers of long-term value in their SEC filings to offer a balanced presentation.

Legal proceedings — The amendments permit registrants to provide hyperlinks or cross-references to other disclosures elsewhere in the same filing (e.g., financial statement footnotes) to satisfy the Regulation S-K requirement to disclose details about material pending legal proceedings.

The amendments also raise the threshold for disclosing environmental proceedings to which a governmental authority is a party to those that the registrant believes will result in sanctions of $300,000 or more (up from $100,000 or more). Registrants will also be able to elect to use a higher threshold that is reasonably designed to result in disclosure of any material proceeding, as long as the threshold does not exceed the lesser of $1 million or 1% of the registrant's current assets.

Risk factors — The amendments require companies to report "material" risk factors, rather than the "most significant" ones. In addition, if a filing's risk factors section exceeds 15 pages, the registrant will have to provide a summary of no more than two pages.

Risk factors will also be required to be organized under relevant headings in addition to the subcaptions currently required. Risks that could apply generically to any registrant will have to be presented at the end of the disclosure in a general risk factors section.

These changes address the lengthy and generic nature of the existing risk factors presented by some registrants. The SEC said the changes will focus registrants on disclosing the risks unique to them that investors would consider important in making investment decisions.

The amendments are effective 30 days after their publication in the Federal Register.

Regulatory actions on emerging markets update

The President's Working Group on Financial Markets (PWG) submitted its **recommendations** on how to protect investors in US-listed companies that are domiciled or have significant operations in jurisdictions, such as China, that are viewed by the US government as not cooperating with US regulators. President Donald Trump sought the recommendations to address the risks to US investors posed by the inability of audit firms that are registered with the Public Company Accounting Oversight Board (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.

Among other things, the recommendations would require PCAOB access to audit workpapers of a listed company's auditor as a condition for initial and continued listing on a US exchange. As an alternative, the recommendation would permit companies in affected jurisdictions to engage an affiliated US-member registered public accounting firm to serve as the co-auditor of the listed company's annual financial statements with an auditor in that jurisdiction. In this model, the US firm would be a co-auditor (issuing an opinion) and would be required to maintain the audit workpapers in the US, giving the PCAOB access to them and the ability to inspect the firm's practices. However, the report acknowledges that existing PCAOB standards do not currently provide guidance related to co-audits, nor do they address the ability of the US firm to maintain necessary documentation to support the opinion in the US. If implemented as recommended, the rules would be immediately effective for new listings and provide a transition period for existing issuers.

Chairman Jay Clayton has directed the SEC staff to prepare rule proposals based on the recommendations. The timing of any potential rulemaking is uncertain. The SEC has encouraged members of the public to submit any views or other information that they would like the SEC staff to consider while developing proposals in response to the PWG recommendations to **emergingmarkets@sec.gov**.

> "Adding clearly financially sophisticated persons to the pool of persons eligible to participate in these financings is a laudable and unassailable policy goal.
>
> — SEC Chairman Jay Clayton

SEC amends accredited investor definition

The SEC adopted **final rules** that expand the definition of an accredited investor to give more individuals and entities that have sufficient knowledge and expertise access to the private capital markets, where there are fewer protections for investors. The amendments add the following new categories of qualifying individuals and entities to the definition:

- Individuals with certain professional certifications and designations that the SEC will maintain and modify as necessary
- A "knowledgeable employee" of a private fund for the purpose of investing in that fund
- Limited liability companies with at least $5 million in assets, registered investment advisers, exempt reporting advisers and rural business investment companies
- Any entity owning investments in excess of $5 million that was not formed for the purpose of investing in the securities offered
- Family offices with at least $5 million in assets under management and their family clients

The amendments allow investors to pool their finances with "spousal equivalents" to meet the income or net worth requirements to qualify as accredited investors.

The amendments did not change the current net worth or income thresholds in the definition.

The amendments also expand the definition of qualified institutional buyer in Rule 144A to add newly identified institutional accredited investors.

The amendments are effective 60 days after their publication in the Federal Register.

Other SEC rulemaking and current practice matters

SEC adopts amendments to enhance disclosures by proxy advisory firms

The SEC adopted **amendments** to its proxy solicitation rules to enhance the accuracy and transparency of the information that proxy advisory firms provide to their clients. The amendments add conditions to relying on Securities Exchange Act of 1934 (Exchange Act)

Rules 14a-2(b)(1) and (b)(3), which provide exemptions from the information and filing requirements of the proxy rules and are typically relied upon by proxy advisory firms. The conditions require proxy advisory firms to:

- Disclose specified conflicts of interest to shareholders in or along with their proxy voting advice
- Develop and publicly disclose policies and procedures such that:
  - Any company that is the subject of voting advice by the proxy advisory firm has that advice made available to them before or at the same time that it is made available to shareholders
  - Shareholders can reasonably expect to be provided with a company's written response to the proxy advisory firm's voting advice in a timely manner before the shareholders' meeting

The SEC also **supplemented** its guidance regarding the proxy voting responsibilities of investment advisers. The supplement provides guidance on what steps an investment adviser should take to demonstrate that it is making voting determinations in a client's best interest.

The amendments are effective 3 November 2020, and the supplemental guidance became effective 3 September 2020.

SEC adopts changes to the shareholder-proposal process

The SEC adopted amendments to the rule that governs the process for including shareholder proposals in a company's proxy statement. The amendments require shareholders to continuously hold at least $25,000 in company securities for one year, up from $2,000, or 1% of company securities, to submit a proposal to be included in the proxy statement. The threshold will fall to $15,000 after at least two years of ownership and $2,000 after three years. The new rule prohibits shareholders from aggregating their holdings for the purposes of satisfying these criteria.

Among other things, the amendments also:

- Clarify that a single person (i.e., a shareholder or a shareholder's representative) may not submit multiple proposals to be considered at the same shareholders' meeting
- Increase the levels of shareholder support a proposal must receive for resubmission at a future shareholder meeting

The amendments are effective 60 days after their publication in the Federal Register and will apply to any proposal submitted for a shareholder meeting held on or after 1 January 2022. However, a shareholder that has continuously held at least $2,000 of a company's securities for at least one year as of the effective date will continue to be eligible to submit proposals for meetings held before 1 January 2023.

SEC stays approval of new NYSE direct listings rules

The SEC **stayed** its recent approval of new direct listing rules for the New York Stock Exchange (NYSE) in response to a request from the Council of Institutional Investors that it review the approval.

The proposed rules are aimed at increasing the appeal of direct listings. Under current NYSE direct listing rules, companies are only able to list existing shares for resale by existing shareholders.

Under the **proposed rules,** a company that has not previously had its common equity securities registered under the Exchange Act would be allowed to sell new shares to the public in a new type of listing known as a "primary direct floor listing" if either:

- The market value of the new shares sold to the public in the direct listing is at least $100 million.
- The market value of the company's shares before the direct listing, together with the market value of the new shares sold to the public, is at least $250 million.

SEC modernizes statistical disclosure requirements for banking registrants

The SEC adopted **rules** to update and clarify the requirements for statistical disclosures that bank and savings and loan registrants include in their SEC filings. The amendments eliminate certain disclosure requirements that overlap with US GAAP, IFRS and other SEC rules and replace Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*, with a new subpart of Regulation S-K.

The rules require disclosure about the following:

- Distributions of assets, liabilities and stockholders' equity, the related interest income and expense, and interest rates and interest differential (e.g., providing disclosures that help users understand components of net interest earnings and evaluate the impact of potential changes in interest rates on future income)
- Weighted average yield of investments in debt securities by maturity
- Maturity analysis of the loan portfolio, including amounts that have predetermined interest rates and floating or adjustable interest rates
- Certain credit ratios and the factors that explain material changes in the ratios or their components during the periods presented
- The allowance for credit losses by loan category
- Information about bank deposits, including average amounts and rate paid, and uninsured amounts

The rules are effective 30 days after their publication in the Federal Register and will apply to fiscal years ending on or after 15 December 2021. Early compliance is permitted.

New C&DIs on pandemic benefits for executives, use of Form S-3 by a SPAC

The SEC's Division of Corporation Finance issued a new **Compliance & Disclosure Interpretation** (C&DI) that provides guidance on whether benefits provided to executive officers because of the COVID-19 pandemic should be considered perquisites and personal benefits.

Perquisites and personal benefits are included in the calculation of a company's most highly compensated executive officers for disclosure purposes and presented in a company's summary compensation table disclosure. The C&DI reiterates the following Commission guidance and says it applies to items provided because of the COVID-19 pandemic:

- An item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties
- An item that confers a direct or indirect benefit and that has a personal aspect is a perquisite or personal benefit unless it is generally available to all employees

> "Today's proposal marks another important step in the Commission's efforts to review, and where necessary, amend disclosure requirements to ensure that investors get the facts and figures they need to make informed decisions.
> — SEC Commissioner Hester Peirce

The Division also issued a C&DI clarifying the use of a Form S-3 registration statement by a special purpose acquisition company (SPAC) or other reporting shell company following its merger with a private operating company. In such cases, the newly merged registrant would need 12 calendar months of Exchange Act reporting history following the transaction before it would be able to use Form S-3.

SEC proposes rule to modernize fund shareholder reports and disclosures

The SEC proposed rule and form amendments that would modernize the disclosure framework for mutual funds and exchange-traded funds registered on Form N-1A (collectively, funds) to better serve the needs of retail investors.

The proposal would require a fund to send its investors its annual and semiannual shareholder reports that highlight important information, such as fund expenses, performance and portfolio holdings, within 60 days of period end. Annual reports would also be required to disclose a summary of material fund changes during the year (such as changes to a fund's principal investment strategy or fees).

The proposal would require shareholder reports to be delivered by mail unless an investor elects electronic delivery. While the proposal would no longer require shareholder reports to include a fund's financial statements, it would still require the fund's unaudited semiannual financial statements and audited annual financial statements to be filed on Form N-CSR within 10 days after the transmission of the shareholder report, posted on the fund's website and delivered to investors upon request.

Under the proposal, funds would continue to provide new investors with a fund prospectus upon initial investment, but in lieu of providing existing investors with an updated annual prospectus, funds would be required to timely notify investors about material fund changes, in addition to providing shareholder reports semiannually. A current prospectus would remain available online and would be delivered to investors upon request.

The proposal would modify prospectus disclosures related to fees and expenses by:

- Replacing the existing fee table in the summary section of the statutory prospectus with a simplified fee summary
- Moving the existing fee table to the statutory prospectus
- Using clearer and simpler terms in the fee table
- Permitting acquired fund fees and expenses to be included in a footnote to the fee table and fee summary rather than as a separate fee table and fee summary line item if a fund invests 10% or less of its assets in the acquired funds

The proposal also would modify prospectus disclosures related to risks by promoting the disclosure of a fund's principal risks, rather than additional disclosures about non-principal risks, and tailoring principal risk disclosures by specifying how principal risks can be assessed.

In addition, the proposal would amend advertising rules for registered investment companies and business development companies to promote more transparent and balanced statements about investment costs.

Comments are due 60 days after publication in the Federal Register.

EY resources

- SEC Reporting Update: *Highlights of trends in 2020 SEC comment letters*

Reminders about disclosures related to COVID-19

Registrants need to continue to update the disclosures in their SEC filings about the effects of the COVID-19 pandemic, current market conditions and their expectations for the future. Companies should also continue to discuss the economic fallout from the outbreak with their audit committees and auditors and reach out to the SEC staff with any questions.

While the SEC staff hasn't issued many comments to registrants about their pandemic-related disclosures in periodic reports, it has issued a number of these types of comments to companies registering securities offerings. This could be a leading indicator of where the staff plans to focus its time on periodic reports.

The comments generally involve the specificity of risk factors and disclosures in management's discussion and analysis, including those related to impairment testing, a company's liquidity position and forward-looking information. Our **SEC Reporting Update: Highlights of trends in 2020 SEC comment letters** provides examples of the SEC staff's comments relating to COVID-19 and other topics that may be useful for companies to consider as they prepare for year-end reporting.

Personnel changes

Crenshaw and Peirce sworn in as SEC Commissioners

Caroline Crenshaw and Hester Peirce were sworn into office as SEC Commissioners for terms ending in June 2024 and June 2025, respectively, after being unanimously confirmed by the US Senate.

Ms. Crenshaw formerly served in various positions at the SEC, including in the Office of Compliance Inspections and Examinations, in the Division of Investment Management, and as counsel to former Commissioners Kara Stein and Robert Jackson Jr.

Ms. Peirce has been a Commissioner since 2018 and has focused on matters of innovation in financial services and led the Commission's efforts to implement the Dodd-Frank Act Title VII regulatory regime. She has also served as senior counsel for the Senate Committee on Banking, staff attorney in the SEC's Division of Investment Management and counsel to former SEC Commissioner Paul Atkins.

McCord named Chief Accountant of the Division of Corporation Finance

Lindsay McCord was named Chief Accountant of the SEC's Division of Corporation Finance. Ms. McCord, who had been serving as acting Chief Accountant of the Division since March 2020, succeeds Kyle Moffatt. She previously served as a Deputy Chief Accountant in the Division, leading a team that provides technical guidance and interpretations of financial statement and disclosure requirements. Before joining the SEC, she was an audit manager at Grant Thornton LLP.

Stoltzfus named SEC Deputy Chief Accountant

Diana Stoltzfus was named Deputy Chief Accountant overseeing the professional practice group in the SEC's Office of the Chief Accountant. Previously, Ms. Stoltzfus was an assurance partner at PricewaterhouseCoopers LLP.

Her appointment follows the departure of former Deputy Chief Accountant Marc Panucci, who had served in the role since 2016.

SEC Enforcement Co-Director Peikin departs agency

Steven Peikin, Co-Director of the SEC's Division of Enforcement, left the SEC after serving in his role for more than three years. During his tenure, Mr. Peikin worked to better position the Division to address emerging threats and increased the Division's efficiency and effectiveness in investigating and prosecuting violations of the federal securities laws.

Stephanie Avakian, who had been a Co-Director of the Division, is now the Director of the Division of Enforcement.

Enforcement activities

Pharmaceutical company charged for improper revenue recognition and misleading disclosures

The SEC announced that a publicly traded pharmaceutical company agreed to pay a $45 million penalty to settle charges of improper revenue recognition and misleading disclosures in SEC filings and earnings presentations. The company's former chief executive officer (CEO), chief financial officer (CFO) and controller also agreed to pay penalties to settle charges against them.

According to the orders, the company allegedly misstated revenue transactions and inaccurately attributed revenue to organic growth when disclosing certain US GAAP and non-GAAP financial measures, among other things. The orders also said the company allegedly failed to disclose the material impact of revenue it received related to an increase in the price of a single drug, and erroneously attributed the revenue to more than 100 unrelated products.

Without admitting or denying the findings, the company's former CEO and CFO agreed to pay civil penalties representing a portion of their incentive compensation. The company's former controller agreed to pay a penalty and to be suspended from appearing and practicing before the SEC as an accountant, with the ability to apply for reinstatement after one year.

> "When public companies and their senior executives tout strong financial measures, they must provide investors with all of the information needed to make fully informed investment decisions.
>
> — Michele Layne, Director, SEC Los Angeles Regional Office

Multi-level marketing company charged with FCPA violations

A public multi-level marketing company agreed to pay more than $67 million to settle charges that it violated the books and records and internal accounting controls provisions of the Foreign Corrupt Practices Act (FCPA). The US Department of Justice and the US Attorney's Office for the Southern District of New York also announced that the company will pay a fine of more than $55 million to settle a parallel criminal action.

The order finds that the company's Chinese subsidiaries allegedly made payments and provided meals, gifts and other benefits to Chinese officials to obtain sales licenses, curtail government investigations and remove negative coverage of the company in state-owned media. Despite indications of high travel and entertainment spending in these subsidiaries and violations of the company's internal FCPA policies, company executives failed to detect and prevent (1) improper payments and benefits and (2) falsified expense reports. The order also finds that the expenses were allegedly recorded inaccurately and that the company failed to devise and maintain a sufficient system of internal controls.

In addition to paying disgorgement and interest, the company agreed to report on the status of its remediation and compliance measures for a three-year period.

Two companies settle charges for misstating EPS

The SEC settled actions against two companies for allegedly improperly reporting earnings per share (EPS) arising from a Division of Enforcement initiative that utilizes risk-based data analytics to uncover potential accounting and disclosure violations caused by earnings management practices.

In one instance, the company was charged with using manual accounting adjustments that were not compliant with US GAAP to meet or exceed analyst consensus EPS estimates. In the other instance, the company was charged with adjusting a valuation reserve to increase EPS and meet consensus estimates.

Both companies agreed to monetary penalties without admitting or denying any wrongdoing. The former chief accounting officer and former CFO of one of the companies also agreed to suspensions from practicing as accountants before the SEC.

Company and CEO charged for ICO fraud and registration violations

The SEC announced charges against an information technology company and its CEO for fraud and registration violations in connection with a $5 million initial coin offering (ICO) of digital asset securities.

According to the order, the company raised approximately $5 million by selling digital tokens to more than 1,500 investors to develop and market a platform to connect employers posting jobs with freelancers seeking work. The order alleges that the tokens were offered and sold as investment contracts and were therefore securities but were sold in unregistered offerings.

The order also alleges that the company and its CEO made false and misleading statements, including claims about the stability and security of its tokens and claims that its platform was faster and more scalable than that of its competitors because it was built on the company's own blockchain, when in fact the platform was developed on the same public blockchain as those of its competitors.

The company and its CEO agreed to settle the charges by consenting to the issuance of the order, which requires the company to disgorge the $5 million raised in the ICO plus prejudgment interest. The order also requires the company and its CEO to destroy all tokens in their possession, issue requests to remove the tokens from any further trading and refrain from participating in any future offerings of digital asset securities. The CEO was required to pay a penalty of $150,000 and is barred from serving as an officer or director of a public company.

What's next at the SEC?

The SEC is working to finalize the remaining proposed rules that it released during the last year as we approach the US presidential election, including its final proposal to simplify and modernize the disclosure requirements of Regulation S-K.