Issue 2, 5 April 2018

SEC in Focus

Quarterly summary of current SEC activities

In this issue:

Companies should consider using Rule 3-13 to seek relief

Securities and Exchange Commission (SEC or Commission) officials are actively encouraging companies to use Rule 3-13 of Regulation S-X to request relief from burdensome financial statement requirements that result in the disclosure of information that exceeds what is important to investors.

Jay Clayton

Soon after he was sworn in last year, SEC Chairman Jay Clayton reminded companies that relief is available under the rule when a company is required "to make disclosures that are burdensome to generate but may not be material to the total mix of information available to investors."[1] He added that the staff is placing a high priority on responding to requests for relief in a timely manner.

Bill Hinman

In a recent speech,[2] Bill Hinman, the Director of the SEC's Division of Corporation Finance (DCF), reiterated the staff's willingness to consider requests and encouraged companies to contact the SEC staff early in the process.

Rule 3-13 gives the Commission the authority to modify or waive a company's financial reporting obligations under Regulation S-X, based on the facts and circumstances, as long as modifying or omitting the disclosure is consistent with investor protection. The Commission has delegated this authority to its staff in the DCF. Under Rule 3-13, companies can seek relief from the requirements of Regulation S-X, which dictates the form and content of the financial statements a company includes in its SEC filings. In addition to requirements for the company's own financial statements, Regulation S-X requires companies to provide financial statements of acquired businesses, equity method investees, subsidiary issuers and guarantors of guaranteed securities, and various other entities. Rule 3-13 is important because it allows the SEC staff to apply judgment when the prescribed rules prevent a company from doing so.

Building a better working world

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- To the Point, *Companies should consider seeking relief from SEC disclosure requirements under Rule 3-13* (SCORE No. 01995-181US)

How we see it

Companies should work with their external advisers to determine whether there are opportunities to seek relief from the SEC staff.

We encourage companies to make these requests, even when they are facing challenging transaction or filing deadlines. We also encourage companies to make requests when the staff's previous decisions suggest that a request may be rejected. In our experience, the staff has been responding quickly, often in less than a week, and previous decisions on a given topic may not reflect the staff's current views. Companies also should know that making such a request won't affect the SEC staff's review of other aspects of their filings.

SEC continues to focus on ICOs

SEC officials continue to express concerns that initial coin offerings (ICOs) may be securities offerings that should be registered. This view has been advanced by Chairman Clayton, the Commissioners and SEC staff since the Commission issued an investigative report on The DAO in July 2017. "I believe every ICO I've seen is a security [offering]," Chairman Clayton said during a Senate Banking Committee hearing on virtual currencies earlier this year.

The Commission has created a page on its website to provide information to investors about the risks and rewards related to ICOs, and to remind gatekeepers and others, including securities lawyers, accountants and consultants, that they need to focus on their investor protection responsibilities with regard to ICOs.

The Chairman and the Commissioners also joined the North American Securities Administrators Association in reminding investors that when they are offered and sold securities, they are entitled to the benefits and protections of state and federal securities laws, which many promoters of ICOs are not following.

During his testimony before the Senate Banking Committee, Mr. Clayton said that "merely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security" and that "tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under US law." Mr. Clayton noted that no ICOs have yet been registered with the SEC.

In a joint statement with the enforcement director of the US Commodity Futures Trading Commission, the co-directors of the SEC's Division of Enforcement said they "will look beyond form, examine the substance of an activity … continue to address violations and bring actions to stop and prevent fraud in the offer and sale of digital [assets]."

The Division of Enforcement followed through on that statement with enforcement actions including:

- The SEC halted an unregistered ICO that allegedly targeted retail investors to fund what the company and its founders claimed to be the world's first decentralized bank that would offer its own cryptocurrency to be used for a broad range of customer products and services.
- The SEC charged a former Bitcoin-denominated exchange and its operator with operating an unregistered online securities exchange and defrauding exchange users by misappropriating their Bitcoins and failing to disclose a cyberattack that resulted in the theft of more than 6,000 Bitcoins.

Stephanie Avakian, co-director of the Division of Enforcement, has said that the SEC has "dozens" of other investigations related to cryptocurrencies and ICOs under way.

Officials from the SEC's Division of Enforcement and the Division of Trading and Markets have said that an online platform that provides a mechanism for trading assets that meet the definition of a security under the federal securities laws must register with the SEC as a national securities exchange or qualify for an exemption. SEC-registered exchanges have rules designed to prevent fraudulent and manipulative acts and practices.

While ICOs and cryptocurrency exchanges have been the primary focus of the SEC's enforcement actions related to cryptocurrencies, the Division of Enforcement also continues to monitor companies that tout their plans to use blockchain or distributed ledger technologies to lure investors and inflate their stock prices. For example, the SEC suspended trading in three issuers because of concerns regarding the accuracy and adequacy of statements they made about recent acquisitions of cryptocurrencies and blockchain technology-related assets.

How we see it

We expect the SEC to continue to closely monitor offerings of digital tokens that have the characteristics of securities and platforms where crypto-assets are traded.

SEC issues cybersecurity guidance

'The Commission believes that it is critical that public companies take all required actions to inform investors about material cybersecurity risks and incidents in a timely fashion.'

– SEC Chairman Jay Clayton

The SEC issued an interpretive release outlining its views on what public operating companies are required to disclose about risks and incidents involving cybersecurity. The Commission-level guidance builds on the SEC Division of Corporation Finance CF Disclosure Guidance: Topic No. 2 – *Cybersecurity*, issued in 2011, in a number of ways, including:

- Clarifying that disclosure controls and procedures should enable registrants to identify cybersecurity risks and incidents, assess and analyze their implications, and make timely disclosures
- Highlighting the importance of maintaining insider trading and Regulation FD policies that effectively address the fact that cybersecurity risks and incidents can constitute material, nonpublic information
- Expanding the existing disclosure guidance to address how the board of directors oversees the management of cybersecurity risk, as well as management's discussion and analysis (MD&A) of how cybersecurity incidents affected reportable segments
- Discussing how materiality, as well as the many laws, rules, regulations and SEC form requirements, must be considered when preparing cybersecurity disclosures

The release does not address the implications of cybersecurity for other regulated entities such as registered investment companies, investment advisers, brokers, dealers, exchanges and self-regulatory organizations.

The SEC also recently charged a former executive of a company affected by a cybersecurity breach with insider trading, alleging that the executive exercised all of his vested options and then sold the shares before the company publicly disclosed the breach.

Chairman Clayton has said that the Commission "will continue to evaluate developments in this area and consider feedback about whether any further guidance or rules are needed."

How we see it

The interpretive release represents a meaningful progression in the SEC's approach to cybersecurity disclosures and related corporate governance considerations. We expect the SEC staff to evaluate registrants' cybersecurity disclosures in response to the interpretive guidance.

EY resources

- SEC Reporting Update, *SEC issues guidance on cybersecurity* (SCORE No. 01030-181US)

SEC rulemaking and implementation

Investment companies' liquidity risk management programs

The SEC issued an interim final rule to extend by six months the deadline for open-end funds to comply with the provisions of the Commission's liquidity risk management program rule related to investment classification, highly liquid investment minimums and board approval. The interim final rule also extends the deadline by six months for the related reporting requirements of Form N-LIQUID and the liquidity disclosures on Form N-PORT. The revised compliance date is 1 June 2019 for larger fund groups (i.e., those with $1 billion or more in net assets) and 1 December 2019 for smaller fund groups.

Other provisions of the liquidity risk management program rule (including the requirements to adopt a liquidity risk management program and to limit illiquid investments to 15% of the fund's net assets) and other provisions of Form N-LIQUID and the liquidity-related changes to Form N-CEN, are still effective on 1 December 2018 for larger fund groups and 1 June 2019 for smaller fund groups.

Investment companies' liquidity disclosure requirements

The SEC proposed amending the public disclosure requirements related to liquidity for certain open-end funds. The proposal would require these funds to disclose information about the operation and effectiveness of their liquidity risk management program in management's discussion of fund performance in their annual reports to shareholders. The requirement in Item B.8 of Form N-PORT for funds to publicly disclose on an aggregate basis the percentage of investments in each liquidity classification category would be rescinded. The proposal also would amend Item C.7 of Form N-PORT to allow funds to split a single holding into more than one liquidity category under certain specified circumstances. Funds would be required to report on Form N-PORT holdings of cash and cash equivalents that are not reported in other sections of the form. Comments are due by 18 May 2018.

Approval of changes to NYSE direct listing rules

The SEC approved a New York Stock Exchange (NYSE) proposal to facilitate direct listings by companies that do not intend to offer shares through an initial public offering (IPO). The NYSE will now allow companies to seek a direct listing without an IPO, and without any unlisted trading, if an independent third party determines that the market value of their publicly held shares is at least $250 million. Previously, without an IPO, spin-off or transfer from another exchange, a company could only list equity on the NYSE at the exchange's discretion and if the market value of its publicly held shares was at least $100 million, based on an independent third-party valuation and the most recent trading price in the unlisted market.

The rule also lists factors indicating when a third party providing the valuation would not be deemed to be independent.

Updates to SEC staff guidance

SEC staff updates its questions and answers on the IFRS XBRL taxonomy

The SEC staff updated its questions and answers on the IFRS XBRL taxonomy to clarify certain items, including that IFRS registrants should refer to the 2018 SEC Reporting taxonomy and the 2018 US GAAP taxonomy to tag required disclosures (e.g., condensed consolidating financial information for guarantors required by Rule 3-10 of Regulation S-X) that are not addressed by the IFRS XBRL taxonomy.

SEC staff updates guidance on non-GAAP financial measures

The SEC staff issued two new compliance and disclosure interpretations (C&DIs) stating that the regulations on the disclosure of non-GAAP financial measures don't apply in additional circumstances related to business combination transactions. The first new C&DI clarifies that the scope exception that applies to non-GAAP financial measures in forecasts provided to financial advisers in a business combination also applies when the same forecasts are provided to boards of directors and board committees. The second new C&DI provides a similar scope exception for non-GAAP financial measures in forecasts provided to bidders in a business combination and disclosed to comply with the anti-fraud and other liability provisions of the federal securities laws.

Other SEC activities

CAQ International Practice Task Force meeting

The Center for Audit Quality (CAQ) International Practice Task Force (IPTF) issued highlights of its 21 November 2017 meeting during which the IPTF and the SEC staff addressed certain practice issues related to foreign private issuers (FPIs) and cross-border transactions:

Companies using the ASC 606 modified retrospective transition method may disclose in MD&A revenue and cost information for historical periods under ASC 606.

- The SEC staff said the August 2017 Compliance and Disclosure Interpretations about draft registration statements apply to FPIs. That is, the SEC staff would not object to an FPI omitting interim financial statements from a draft registration statement that would be required to meet the timeliness requirements (or more current information requirement) of Item 8.A.5 of Form 20-F, if those financial statements will be superseded by interim financial statements for a subsequent interim period no later than the first public filing. The SEC staff recommended that the FPI submit a transmittal letter laying out its timeline and the financial information it reasonably expects to include in its public filing.
- The SEC staff encouraged companies that are acquiring foreign businesses to consult with the staff about their facts and circumstances and discuss whether relief would be appropriate. For example, the SEC staff said it would consider what relief could be available when Rule 3-05 or Forms S-4 or F-4 require a target company that previously had financial statements audited under International Standards of Auditing to obtain a reaudit of those financial statements using US generally accepted auditing standards.

Remarks at the SEC Speaks conference

SEC staff members from the DCF shared their views at the SEC Speaks conference on various topics, including:

- While the SEC staff will not object to registrants disclosing non-GAAP measures that exclude the one-time effects of the Tax Cuts and Jobs Act, registrants should consistently make all such adjustments and not cherry-pick which items to exclude. Registrants that make these adjustments to measures for the period that includes the enactment date also need to make similar adjustments to non-GAAP measures for subsequent periods to exclude all changes in enactment date provisional amounts that they record during the measurement period under Staff Accounting Bulletin (SAB) 118.
- The SEC staff will not object to a company providing supplemental MD&A disclosures when it adopts Accounting Standards Codification (ASC) 606 using the modified retrospective transition method. Companies using this method may disclose in MD&A revenue and cost information for historical periods under ASC 606. A registrant may only disclose a supplemental measure of profit (e.g., operating income) if it has been able to determine the retrospective effect of ASC 606 on all of the measure's components. Alternatively, the SEC staff will not object to such a company presenting supplemental discussion in MD&A of the results for the year of adoption pursuant to ASC 605; however, the SEC staff will likely challenge MD&A that continues to present results under ASC 605 beyond the year of adoption.

Current practice matters

2018 US GAAP financial reporting and SEC reporting taxonomies available for use

The SEC staff has updated the EDGAR system to allow companies to use the 2018 US GAAP financial reporting taxonomy and a separate new SEC reporting taxonomy. The US GAAP financial reporting taxonomy includes updates for new accounting standards and other improvements.

The SEC staff strongly encourages companies to transition to the 2018 taxonomies for their earliest reporting periods ending after 12 March 2018 (e.g., the first quarter Form 10-Q for calendar-year registrants). While companies may continue to use the 2016 and 2017 US GAAP taxonomies, the staff is expected to remove the 2016 taxonomy from EDGAR before June 2018.

Personnel changes

Kyle Moffatt named Chief Accountant in DCF

Kyle Moffatt was named Chief Accountant of the SEC's DCF. Mr. Moffatt, who had been serving as Acting Chief Accountant of DCF since January 2018, succeeds Mark Kronforst. Mr. Moffatt previously served as an Associate Director of DCF's Disclosure Operations and an Associate Chief Accountant in DCF's Office of Chief Accountant.

Enforcement activities

Medical products company and executives charged with fraud

A privately held medical products company and its chief executive officer (CEO) agreed to settle charges alleging that more than $700 million was raised from investors in exempt offerings by exaggerating or making false statements about the company's technology, business and financial performance.

Without admitting or denying the charges, the CEO agreed to pay a $500,000 penalty, to be barred from serving as an officer or director of a public company for ten years and to convert her supermajority of Class B shares to Class A shares.

Mining company charged with FCPA violations

A mining company agreed to settle charges that it violated the books and records and internal accounting controls provisions of the Foreign Corrupt Practices Act (FCPA).

The SEC alleged that between 2010 and 2014, the company failed to timely implement sufficient internal controls, and once the internal controls were implemented, the company failed to maintain them. Among other things, the company failed to remediate issues that led to payments being made to vendors and consultants without reasonable assurance that the transactions were consistent with their stated purpose or compliant with policies prohibiting payments to government officials. The SEC said the company also failed to accurately describe some of the payments in its books and records.

Without admitting or denying the findings, the company agreed to pay a $950,000 civil penalty and to report to the Commission periodically for one year on the status of its remedial actions.

Energy company and former executives charged with overstating revenue

A company that makes energy storage and power delivery products and several of its former executives agreed to settle charges that they overstated revenue for a little over a year. The company later restated its financial statements.

According to the order, the company, through a sales executive, used improper tactics to prematurely record revenue, including entering into customer side deals with contingent payments and full right of return, channel stuffing, extending payment terms, falsifying

purchase orders and third-party confirmations, and instructing certain distributors to order product they neither wanted nor needed at quarter end. Other executives were charged with failing to adequately respond to red flags and overriding and ignoring controls such as automated credit limits or overdue receivables.

Without admitting or denying the charges, the company agreed to certain undertakings and to pay a civil penalty of $2.8 million, and the sales executive agreed to pay a penalty of $50,000 and to be barred for five years from serving as an officer or director of a public company.

Record whistleblower awards

The SEC said it has issued two whistleblower awards that exceed the previous record, with two whistleblowers sharing nearly $50 million and another receiving more than $33 million. The previous high was $30 million awarded in 2014. More than $262 million has been paid since the first award was issued in 2012.

The whistleblower program was created by Congress as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act and implemented by the SEC in 2011 to provide monetary incentives for individuals to report possible violations of the federal securities laws to the SEC.

OCIE 2018 priorities

The SEC's Office of Compliance Inspections and Examinations (OCIE) announced that it will focus in 2018 on examining critical market infrastructure, duties to retail investors, developments in cryptocurrency, ICOs and secondary market trading.

What's next at the SEC?

We expect the SEC staff in the DCF to begin issuing comments on registrants' application of ASC 606, accounting for the effects of tax reform and the application of SAB 118, and cybersecurity disclosures. We also expect the SEC staff to continue to closely monitor developments in ICOs and cryptocurrency exchanges.

Given the comments by senior SEC leadership, we expect the SEC staff to be amenable to granting more Rule 3-13 requests and to working collaboratively with companies to relieve financial statement burdens imposed by Regulation S-X that are unnecessary to protect investors. However, the staff cannot grant relief that is not requested, so companies need to be proactive. Companies should work with their external advisers and consider reaching out to the staff to discuss potential relief.

Endnotes:

1 https://www.sec.gov/news/speech/remarks-economic-club-new-york.
2 https://www.sec.gov/news/speech/speech-hinman-020118.