SEC staff expects robust Brexit disclosures

In recent remarks, William Hinman, Director of the Securities and Exchange Commission (SEC or Commission) Division of Corporation Finance (DCF), reiterated that SEC officials expect disclosures about the effects of the United Kingdom’s withdrawal from the European Union, known as Brexit, to be robust and tailored to a company’s facts and circumstances.

While acknowledging the uncertainty about the terms of the withdrawal and its timing (the deadline has now been extended until 31 October 2019), Mr. Hinman suggested that management consider the nature of information discussed with the board of directors in evaluating appropriate disclosures about the risks of Brexit. Specifically, he said companies should consider qualitative and quantitative disclosure related to risks such as:

- Exposure to new regulatory risk (e.g., uncertainty about applicable laws and regulations and/or transition agreements)
- Supply chain risks due to the lack of free trade agreements or changes to customs administrations or tariffs on exports and imports
- Possible loss of customers, decreases in revenues or increases in costs resulting from changes in exchange rates or tariffs
- Exposure to foreign currency devaluation and exchange rate risk
- The risk that material contracts may require renegotiation or termination
- Whether Brexit affects financial statement recognition, measurement and disclosure items (e.g., inventory write-downs, long-lived asset impairments, collectibility of receivables, assumptions underlying fair value measurements, foreign currency matters, hedge accounting, income taxes)
Mr. Hinman said that, although more companies are making disclosures about Brexit, he sees room for improvement. While acknowledging that disclosures will vary greatly across industries and companies, he cautioned that “there should not be material gaps between how the board is briefed and how shareholders are informed.”

**SEC emphasizes principled disclosure approach on sustainability issues**

Certain Commission officials have made public comments about environmental, social and governance (ESG or sustainability) disclosures, which some investors and other stakeholders are advocating.

Regarding the development of third-party ESG disclosure frameworks, SEC Chairman Jay Clayton recently told the Investor Advisory Committee (IAC) that “although third-party standards relating to ESG topics may allow for comparability across companies, that does not mean that issuers should be required to follow these frameworks in order to comply with SEC rules.” He also addressed the IAC’s recent recommendations regarding disclosures about human capital, saying “My view is that to move our framework forward we should not attempt to impose rigid standards or metrics for human capital on all public companies. Rather I think investors would be better served by understanding the lens through which each company looks at its human capital.” Commissioner Elad Roisman said at the IAC meeting he agreed with Chairman Clayton’s remarks. Separately, Commissioner Hester Peirce noted that US securities laws already provide for material ESG disclosures.

In addition, Mr. Hinman recently said the market is still evaluating ESG disclosures, including the suitability of using a specific set of reporting standards and whether those should be principles-based or prescriptive. He noted that the SEC is closely monitoring market approaches and indicated he does not favor regulation at this point.

Mr. Hinman also highlighted considerations for disclosures about climate and weather-related matters. The SEC staff believes its 2010 interpretive release, which describes how existing SEC disclosure requirements may apply to climate-related issues, remains a relevant and useful tool. Mr. Hinman also reminded companies that if climate-related matters present a material risk, the board’s role in managing that risk should be disclosed. To that end, Mr. Hinman believes that the SEC’s cybersecurity guidance, which addresses board risk management, may provide useful information for companies preparing ESG disclosures.

**How we see it**

Based on officials’ recent remarks, we expect the SEC to continue to monitor ESG disclosure developments without endorsing any specific standards.

**EY comment letter on quarterly reporting requirements**

In our letter responding to the SEC’s request for comment on how the Commission might revise the current requirements related to the nature, timing and frequency of interim reporting, we highlighted the benefits to investors of quarterly reporting and auditor involvement with quarterly financial statements. We also suggested that the SEC consider making targeted improvements, such as providing the option to limit the financial statements and management’s discussion and analysis (MD&A) in Form 10-Q to the year-to-date periods, in addition to encouraging the Financial Accounting Standards Board to reconsider the volume of disclosure requirements for interim financial statements. We also suggested the SEC consider providing an option to report semiannually to smaller reporting companies that are not listed on an exchange.
SEC rulemaking

SEC adopts rule to modernize and simplify Regulation S-K disclosures

The SEC adopted a final rule to modernize and simplify certain disclosure requirements in Regulation S-K and the related rules and forms, as required by the Fixing America’s Surface Transportation (FAST) Act. These changes include:

- Revising the requirements for MD&A to allow more flexibility, including allowing registrants that provide three years of financial statements to omit discussion of the earliest year and cross-reference its discussion in a previous filing
- Allowing registrants to redact confidential information from material contract exhibits to their filings, without filing a confidential treatment request, if the information is not material and disclosing it would likely cause competitive harm
- Removing the example risk factors in Regulation S-K to encourage more meaningful company-specific disclosure and relocating the disclosure requirements to the new Item 105 of Regulation S-K because they apply to filings other than registration statements
- Clarifying the description of property requirements to emphasize that the disclosures should only include properties that are material to the registrant and permitting registrants to provide disclosures on a collective basis when appropriate
- Requiring XBRL data tagging for items on the cover pages of certain filings, as well as the use of hyperlinks to information that is incorporated by reference and available on EDGAR

The rule also prohibits cross-references in financial statements to disclosures in other parts of the filing or the incorporation of information by reference from other filings into financial statements. However, incorporating by reference or cross-referencing to information outside of the financial statements is allowed if it is specifically permitted by SEC rules, US GAAP or IFRS as issued by the International Accounting Standards Board.

The SEC also changed the rules and forms that apply to investment companies, investment advisers and foreign private issuers to reflect these changes.

The staff in the SEC’s DCF announced a compliance review process for redacted contract exhibits and addressed related transition issues concerning requests for confidential treatment.

The provisions related to the redaction of confidential information in exhibits are effective upon publication in the Federal Register, and the provisions requiring XBRL data tagging are subject to a three-year phase-in, depending on the registrant’s filing status. All other provisions are effective 2 May 2019.

SEC proposal would amend offering rules for BDCs and closed-end funds

The SEC proposed amending certain of its rules to align the registration, communications and offering rules for business development companies (BDCs) and registered closed-end funds with those that apply to operating companies. The proposal would allow BDCs and closed-end funds that meet certain filing and reporting history requirements to offer securities using a new short shelf registration statement if they have a public float of at least $75 million and to qualify for well-known seasoned issuer status if they have a public float of at least $700 million.

The proposal would allow them to follow many of the communication rules related to securities offerings that apply to operating companies. In addition, the proposal would amend structured data requirements, including requiring BDCs to file financial statements using inline XBRL.
The proposal would amend periodic and current reporting requirements, including (1) requiring closed-end funds to provide management’s discussion of fund performance in their annual reports and file current reports on Form 8-K and (2) requiring BDCs and closed-end funds to disclose material changes to investment objectives or policies in Form 8-K, as well as material writedowns of significant investments.

The proposal would also eliminate the requirement for BDCs and closed-end funds to provide new purchasers with a copy of all previously filed materials that are incorporated by reference into the registration statement. Instead, they would be able to make that material available on their websites. Comments are due 10 June 2019.

**SEC proposes expansion of ‘test-the-waters’ accommodation**

The SEC proposed allowing all issuers to gauge market interest in registered securities offerings by discussing potential offerings with certain institutional investors before filing a registration statement. Currently, only emerging growth companies (EGCs) are allowed to make these test-the-waters communications.

The proposal is intended to give companies more flexibility to determine whether to proceed with a registered offering before preparing a registration statement and incurring other costs. By enhancing the ability of issuers to conduct successful offerings and lowering the cost of capital, the SEC hopes to encourage more registered public offerings. Comments on the proposal are due by 29 April 2019.

**Other SEC activities**

**CAQ – SEC Regulations Committee meeting highlights**

At the Center for Audit Quality’s SEC Regulations Committee meeting in March 2019, the SEC staff clarified that EGCs that elected private company transition for the new revenue recognition standard (i.e., calendar-year EGCs that will adopt the standard for the year ending 31 December 2019 but not for the quarters during 2019) are encouraged but not required to reflect the standard’s adoption in the 2019 quarterly information provided for comparative purposes in their 2020 Form 10-Qs. This differs from what the Staff communicated in December 2018.

The SEC staff reaffirmed that EGCs that adopt the standard in 2019 are not required to recast their 2019 quarterly information in the quarterly financial data table in their 2019 Form 10-K to reflect the new standard. However, these EGCs should provide clear disclosure that the accounting in the quarters differs from that in the annual period.

**How we see it**

EGCs that elected transition date relief should be mindful about complying with the SEC staff’s transition guidance as they prepare to adopt the new revenue standard this year. EGCs should also continue to be aware of when they might lose their EGC status and the related reporting implications.

**Shareholder proxy proposals on mandatory arbitration receive attention**

The SEC staff issued a no-action letter in response to a company’s request to omit a shareholder proposal requesting that the board change the company’s bylaws to require shareholder claims arising under the federal securities law to be addressed through mandatory arbitration. The staff concluded that it would not recommend an enforcement action if the company excluded the shareholder’s proposal based on the Company’s assertion that the proposed change would violate federal law and state law. However, the Staff noted that it was not expressing a view on whether the shareholder’s proposed change would violate the law.
In a public statement, Chairman Clayton acknowledged that mandatory arbitration for shareholder disputes is a complex legal matter, and, in this particular case, it was interpreted differently by the company and the shareholder proponent. Noting that the SEC staff’s letter reflected only informal views, Chairman Clayton said “A court is a more appropriate venue to seek a binding determination of whether a shareholder proposal can be excluded.”

SEC staff issues framework for analyzing whether a digital asset is a security
The SEC staff issued a framework for analyzing whether a digital asset, such as a token or coin, meets the definition of a security under US securities laws. The framework is built on the analysis of an investment contract that the US Supreme Court laid out in *SEC v. Howey* in 1946 in what became known as the Howey test. Under this test, a digital asset would meet the definition of a security if it involves an investment of money in a common enterprise with a reasonable expectation of profit derived from the efforts of others. The framework issued by the staff of the SEC’s Strategic Hub for Innovation and Financial Technology (FinHub) identifies characteristics that market participants should consider to determine whether and when a digital asset is offered or sold as an investment contract and therefore is a security.

The SEC’s DCF also issued a response to a no-action request indicating it will not recommend enforcement action if the digital tokens described in the request were offered or sold without registration because, among other things, those tokens will only be used to prepay for services within an existing business and the token proceeds will not be used for development. The response illustrates how the SEC staff applied the framework to a specific fact pattern.

President Trump to nominate Allison Lee for SEC Commissioner
President Donald Trump announced his intent to nominate Allison Lee to serve as an SEC Commissioner for a term that would expire in June 2022. If confirmed, Ms. Lee would fill the vacant seat previously held by Kara Stein. Ms. Lee served at the SEC staff from 2005 to 2018, including serving in the Division of Enforcement and as counsel to former Commissioner Stein.

Enforcement activities
Companies settle charges for failing to maintain ICFR
Four public companies settled charges in January 2019 for failing to maintain internal control over financial reporting (ICFR). According to the SEC’s orders, these companies repeatedly disclosed material weaknesses in ICFR for a period ranging from seven to 10 consecutive years. The failures pertained to certain high-risk areas of the companies’ financial statements.

The Commission noted that despite being contacted by the SEC staff, three of the companies took months or years to remediate the weaknesses, while one company has not yet completed its remediation. Melissa Hodgman, Associate Director of the SEC’s Division of Enforcement, said “Companies cannot hide behind disclosures as a way to meet their ICFR obligations,” adding that “disclosure of material weaknesses is not enough without meaningful remediation.”

Without admitting or denying the findings, each of the companies agreed to cease and desist orders, payment of civil penalties and certain other undertakings.

Transportation company executives implicated in alleged financial reporting fraud
The former CFO and two former segment controllers of a shipping and logistics company have been charged with materially misstating the company’s results of operations from 2013 to 2017 to meet quarterly earnings guidance and analysts’ projections. The SEC’s complaint
alleges the earnings manipulations included improperly deferring expenses, not writing down assets that were worthless and receivables that were uncollectable, and overstating earnout liabilities related to acquisitions to create a “cushion” that could be accessed in future quarters to offset expenses.

The SEC is seeking permanent injunctions, penalties, and officer-and-director bars against all defendants, as well as disgorgements or clawback of bonuses and other incentive-related compensation paid while the alleged fraud was taking place. The Fraud Section of the US Department of Justice also filed criminal charges against the three former financial officials.

What’s next at the SEC?

We expect the SEC staff to begin issuing comments on disclosures related to Brexit and to scrutinize disclosures about emerging risk areas such as cybersecurity. We also expect the SEC staff to closely monitor disclosures under the new lease accounting standard that calendar-year public companies adopted in the first quarter and to continue evaluating companies’ use of non-GAAP financial measures.

Endnotes:

1 Item 407(h) of Regulation S-K and Item 7 of Schedule 14A.
2 Rule 14(a)-8 of the Securities Exchange Act of 1934 stipulates that management may omit a shareholder proposal from the proxy statement if implementation would involve a violation of state, federal, or foreign law by the registrant.
3 Photo: LinkedIn.