SEC proposes more changes to Regulation S-K requirements

The Securities and Exchange Commission (SEC) proposed more amendments to Regulation S-K that would modernize the description of business, legal proceedings and risk factors disclosure requirements.

The proposal is intended to simplify the disclosure requirements and provide investors with more meaningful disclosures. It is part of the SEC’s disclosure effectiveness initiative and follows its adoption of a final rule in May 2019 to modernize and simplify certain other requirements in Regulation S-K.

“The proposals reflect a thoughtful mix of prescriptive and principles-based requirements that should result in improved disclosures and the elimination of unnecessary costs and burdens,” SEC Chairman Jay Clayton said.

The proposal would modify the description of business disclosure requirements (Item 101 of Regulation S-K) to provide a non-exhaustive list of examples of topics that could be material to the business instead of the 10 prescribed items that registrants are currently required to disclose.

It would also eliminate the requirement to discuss the development of the registrant’s business over the past five years and instead give registrants the flexibility to choose a timeframe that reflects their facts and circumstances. In filings after an initial registration statement, registrants would be permitted to present only material updates and include a hyperlink to the most recently filed disclosure that, together with the update, would present a complete discussion.

When material, the proposal would also require disclosures about human capital resources and related measures or objectives on which management focuses, such as development and/or retention of employees.
The proposal would amend the requirements for the discussion of legal proceedings (Item 103 of Regulation S-K) to permit registrants to include a hyperlink or cross-reference to information about legal proceedings disclosed elsewhere in the same filing. In addition, it would require a registrant to disclose any environmental proceedings in which a government authority is a party unless the registrant reasonably believes it won’t result in sanctions of $300,000 or more, up from $100,000.

The proposal also would amend the risk factor disclosure requirements in Item 105 of Regulation S-K to require registrants to report “material” risk factors, rather than their “most significant” risk factors, and to require registrants to provide a summary risk factor disclosure if the risk factors section of a filing exceeds 15 pages.

Comments are due by 22 October 2019.

How we see it
This is the first time the SEC has proposed requiring human capital metrics beyond headcount. The proposal is consistent with a recent recommendation from the SEC’s Investor Advisory Committee that human capital disclosure requirements should reflect the circumstances of a particular business and avoid a “one-size-fits-all” approach.

The proposal includes several examples of human capital metrics that issuers could use in their disclosures. Some of these metrics were discussed in the 2018 report from the Embankment Project for Inclusive Capitalism (EPIC), which identified value drivers important for sustainable and inclusive growth as well as potential metrics to assess them. The EY global organization co-created the EPIC report.

Guidance on investment advisers’ proxy voting responsibilities
The SEC provided guidance on the proxy voting and related disclosure responsibilities of investment advisers, including when they retain a proxy advisory firm to help them with aspects of those responsibilities. The SEC also issued an interpretation that proxy voting advice generally constitutes a solicitation subject to the federal proxy rules. This means that voting advice cannot contain any statements that are false or misleading with respect to any material fact.

“In the past two decades, the proxy process has become one of increasing complexity, and also importance, to investors, issuers and investment advisers,” Chairman Clayton said. “During this time, investment advisers have assumed a much greater role in our marketplace and, consequently, a greater role in the area of shareholder-company engagement.”

The new guidance and interpretation were largely seen as a response to calls from businesses for oversight of proxy advisory firms that advise investors on voting their shares. Chairman Clayton was joined by Republican Commissioners Elad Roisman and Hester Peirce in supporting the releases. Democratic Commissioners Robert Jackson Jr. and Allison Lee dissented, citing the lack of comprehensive analysis and study in the releases, as well as the increased risks, costs and time pressures resulting from the new guidance.

The guidance and interpretation became effective 10 September 2019.

How we see it
The releases provide Commission guidance that carries more weight than the previous SEC staff-level guidance, but they do not impose additional substantive requirements like Commission rules and regulations. Formal rule changes may come in the future as part of the SEC’s planned overhaul of the proxy voting system.
Other SEC rulemaking
SEC extends ‘test-the-waters’ accommodation to all issuers
The SEC adopted a final rule that allows all issuers to gauge market interest in a possible initial public offering or other registered securities offering in discussions with certain institutional investors before or after filing a registration statement.

Previously, only emerging growth companies were allowed to test the waters in this manner. The rule is intended to help all issuers evaluate market interest before they incur the costs associated with a public offering. It reflects Chairman Clayton’s focus on encouraging more companies to enter the US public equity markets. The rule is effective 60 days after publication in the Federal Register.

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

Disclosures required under the proposal would include:
• Distribution of assets, liabilities and stockholders’ equity, the related interest income and expense, and interest rates and disclosures about components of net interest earnings that allow users to evaluate the impact of potential changes in interest rates on future income (interest differential)
• 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
• Disaggregation of certain credit quality indicators and credit ratios, such as net charge-offs, the allowance for credit losses to total loans and nonaccrual loans to total loans
• Information about bank deposits, including uninsured amounts

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

Other SEC activities and current practice matters
Division of Corporation Finance reorganizes disclosure program
The SEC’s Division of Corporation Finance announced a reorganization of its disclosure program. Among other changes, the program’s 11 former Assistant Director offices have been consolidated into the following seven offices:
• Energy & Transportation
• Finance
• Life Sciences
• Manufacturing
• Real Estate & Construction
• Technology
• Trade & Services
Companies may notice that their filings have been assigned to new reviewers because of the reorganization. The SEC said the staff will continue to assign companies to Assistant Director offices using Standard Industrial Classification codes. These assignments can be viewed at the top of a company’s EDGAR filing history page. Active filing reviews will be completed as previously assigned, to the extent practicable.

**SEC staff encourages registrants to proactively manage LIBOR transition**

The SEC staff issued a statement encouraging companies that have not already done so to begin managing their transition away from the London Interbank Offered Rate (LIBOR), which is expected to be phased out in 2021. While the statement is focused on LIBOR, the SEC staff noted that companies should also monitor other reference rates undergoing transition.

In the statement, the staff of the Office of the Chief Accountant said the transition from LIBOR could have a significant effect on an issuer’s accounting and financial reporting. Areas the staff highlighted include modifications of the terms of debt instruments, hedging activities, inputs used in valuation models and potential income tax consequences.

“There are approximately $200 trillion in notional transactions referencing US Dollar LIBOR, and the Federal Reserve estimates that more than $35 trillion of these obligations will not mature by the end of 2021,” said Chairman Clayton. “This is not a small issue, and it will not resolve itself...market participants should assess their exposure to LIBOR and decide how to actively manage that risk, and they should ensure that any contracts that extend beyond 2021 either (i) reference LIBOR and have effective fallback language or (ii) do not reference LIBOR.”

The staff of the Division of Corporation Finance said it is important for companies to keep investors informed about their progress in managing the transition from LIBOR. Potential disclosures the staff said companies might need to make include risks, if material, related to the transition and how they are being mitigated.

The Financial Accounting Standards Board (FASB) separately proposed providing temporary optional expedients and exceptions to the US GAAP guidance on contract modifications and hedge accounting in light of the expected market transition from LIBOR and other reference interest rates to alternatives, such as the Secured Overnight Financing Rate. The proposal would provide relief in some of the areas highlighted by the SEC staff.

**Commission roundtable on effects of short-termism in reporting**

The SEC staff hosted a roundtable discussion on 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.

In his remarks, Chairman Clayton noted that the focus should be on the needs of Main Street investors. He said he was concerned that public investment could shrink as the focus on short-termism drives more companies to remain private.

Panelists generally agreed that the short-term focus is a problem for public companies and is a factor in companies choosing to remain private longer. However, no clear regulatory solution was identified.

Panelists expressed interest in streamlining interim disclosure requirements and support for the SEC’s effort to make disclosures more effective. They did not call for a reduction in the frequency of interim reporting.
The SEC had 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 sought comment on 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 stakeholders to continue to submit comments.

How we see it

We support quarterly reporting because it gives investors access to timely and decision-useful information, but we believe there are opportunities for the SEC and the FASB to reduce the cost and burden of providing that information.

Both companies and investors have expressed a need to look beyond the financial metrics in quarterly reports to measures related to long-term value creation. We support enhancements to the current reporting model that better communicate company initiatives to create long-term value.

Recent SEC comment letter trends

The number of comment letters issued by the SEC staff in the last year continued to decline. As expected, revenue recognition was the most frequent area of comment in the 12 months ended 30 June 2019, a period that included the first year many companies applied the new guidance in Accounting Standards Codification 606. The SEC staff also continued to focus on the presentation of non-GAAP financial measures, though the number of comment letters citing this topic declined significantly.

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* This category includes comments on MD&A topics, in order of frequency: (1) results of operations (20%), (2) critical accounting policies and estimates (10%), (3) liquidity matters (8%), (4) business overview (6%) and (5) contractual obligations (2%). Many companies received MD&A comments in more than one category.

** This category includes SEC staff comments on fair value measurements under Accounting Standards Codification Topic B20, Fair Value Measurement as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

*** This topic was not among the top 10 in 2018.

Over the coming year, the SEC staff is expected to focus on companies’ disclosures about the expected market transition from LIBOR and risks associated with the United Kingdom’s plan to withdraw from the European Union (known as Brexit). Chairman Clayton recently encouraged companies to continue to prepare for Brexit and to inform their investors of its potential effects, noting that the SEC is continuing to work with domestic and non-US counterparts to identify and plan for the potential effects of Brexit, which is currently scheduled for 31 October 2019.
SEC staff announcement on no-action requests for shareholder proposals
The SEC staff in the Division of Corporation Finance announced that, starting with the 2019-2020 shareholder proposal season, it may respond orally instead of in writing to some no-action requests to exclude shareholder proposals from a proxy statement. The staff said it intends to issue response letters only when it believes doing so would “provide value” (e.g., provide broadly applicable guidance). In some situations, the staff may decline to express a view on a request, but parties should not interpret that as an indication that a proposal must be included in the proxy statement.

Shareholders meeting certain eligibility criteria may submit a proposal for inclusion in a proxy statement under Rule 14a-8 of Regulation 14A. While management may exclude certain shareholder proposals from the proxy statement, it has the burden of determining whether the proposal may be properly omitted and of following certain notification protocols.

Enforcement activities
SEC charges REIT with manipulation of non-GAAP performance measure
The SEC charged a publicly traded real estate investment trust (REIT) with fraud, as well as its CEO, chief financial officer, chief accounting officer (CAO) and senior vice president of accounting.

According to the complaint, the executives manipulated one of the REIT’s non-GAAP measures in order to meet the growth targets the company had announced. The SEC claims that the non-GAAP measure in question was a key metric relied upon by analysts and investors to evaluate the REIT’s performance.

The SEC complaint seeks a permanent injunction, disgorgement plus interest and penalties, and officer-and-director bars. Without admitting or denying the allegations, the company agreed to pay a $7 million penalty and to comply with certain corrective undertakings. The Justice Department also filed criminal charges against the executives.

The company’s CAO and senior vice president of accounting pleaded guilty to the criminal charges and have agreed to partial judgments against them, subject to court approval.

Company charged for making misleading disclosures about risks of data misuse
The SEC filed charges against a social media company for allegedly making misleading disclosures about the risks of misuse of user data. Without admitting or denying the findings, the company agreed to the entry of a final judgment ordering a $100 million fine.

The SEC asserted that despite the company’s discovery that a third-party developer had misused user data, the company described the risks of misuse of user data in its public filings as merely hypothetical and didn’t update those disclosures for more than two years following the initial discovery. The SEC’s complaint also said that during this period, the company did not have the required policies or procedures in place to assess the results of its internal investigation into the misuse of the data and to make sure its disclosures in its public filings were accurate.

Media analytics company charged with overstating revenue
A global information and media analytics company and its former CEO have been charged with overstating revenue by approximately $50 million.

According to the SEC’s orders, the company, at the direction of its former CEO, entered into nonmonetary transactions to exchange sets of data with a counterparty and overstated revenue by improperly inflating the fair value of the data it delivered. The orders also said the former CEO misled the company’s internal accountants and its external auditor.
Without admitting or denying the findings, the company agreed to pay a penalty of $5 million. The former CEO agreed to pay a penalty of $700,000 and reimburse the company $2.1 million representing profits from the sale of company stock and incentive-based compensation.

**Pharmaceutical company charged with accounting and disclosure failures**

A pharmaceutical company was charged by the SEC with failing to disclose possible material losses related to a Justice Department investigation into its pricing practices and failing to accrue the estimated loss once it was probable and reasonably estimable.

The charges relate to a two-year investigation by the Justice Department into the misclassification of the company’s largest revenue and profit generating product under the Medicaid Drug Rebate Program, which allowed the company to overcharge the government for sales of the product to Medicaid patients. The company was informed of the misclassification in October 2014, and the Justice Department launched the investigation in November 2014.

In the complaint, the SEC alleged that the company failed to disclose or accrue for the possible loss related to the Justice Department investigation until October 2016, when it announced a $465 million settlement. The SEC also alleged that the company’s 2014 and 2015 risk factor disclosures were misleading because they failed to disclose that the company had been informed that its product was misclassified.

Without admitting or denying the findings, the company agreed to pay a penalty of $30 million.

**Companies charged for making misleading statements to investors**

An automaker has agreed to pay $40 million, and a direct selling company has separately agreed to pay $20 million, to settle charges that they made false and misleading statements to investors.

The SEC claimed that the automaker issued monthly press releases touting year-over-year retail sales growth for every month from 2012 through 2016, when the streak had actually been broken in 2013.

The SEC stated that the direct selling company misinformed investors in its quarterly and annual SEC filings that its business model in China differed from the model it used in other countries because of Chinese laws banning multi-level marketing. The SEC claimed that these representations were untrue because there were only immaterial differences between the compensation model the company used in China and the model it used in the rest of the world.

Without admitting or denying the findings, the companies agreed to pay the SEC fines and to cease and desist from further violations.

**What’s next at the SEC?**

The SEC continues to focus on finalizing rules to streamline disclosure requirements for certain registered debt offerings and acquired businesses, among other things. The agency has also prioritized rulemaking to improve the proxy voting process, which is known as proxy plumbing.

Chairman Clayton has signaled that the Commission will take a fresh look at expanding access to the private capital markets while preserving investor protection.