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SEC in Focus

Quarterly summary of current SEC activities

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Commission tackles rulemaking before Piwowar's departure

The Securities and Exchange Commission (SEC or Commission) approved several final rules and proposals at its latest open meeting, the last one before Commissioner Michael Piwowar's departure.

Amendments to smaller reporting company definition

The SEC amended the definition of a smaller reporting company (SRC) to allow more companies to provide scaled disclosures in SEC filings. Under the new definition, a company will initially qualify for SRC status if it has either (1) a public float of less than $250 million (up from $75 million) or (2) annual revenues of less than $100 million as of the most recently completed fiscal year and it has no public float (i.e., it doesn't have any public common equity outstanding or a public market price for its common equity) or it has a public float of less than $700 million. The SEC did not change the current public float thresholds for accelerated and non-accelerated filers.

For the first fiscal year ending after the rule becomes effective, a registrant can qualify as an SRC if it meets either of these thresholds even if it previously did not qualify as an SRC.

After the initial determination, a registrant that was not previously an SRC may qualify as an SRC if its public float falls below $200 million at the determination date or if its revenues for the most recently completed fiscal year are less than $80 million and it has a public float of less than $560 million (including if it has no public float).

The SEC also amended Rule 3-05 of Regulation S-X to allow a registrant to omit the financial statements of its acquired or to be acquired business for the earliest of the three fiscal years otherwise required by the rule if the net revenues of that business are less than $100 million (up from $50 million) in the most recent fiscal year.

The amendments will be effective 10 September 2018.

Building a better working world

The SEC did not raise the $75 million public float threshold in the definition of an accelerated filer. As a result, some SRCs may remain subject to accelerated reporting deadlines and the requirement for an auditor attestation on internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act (SOX). However, SEC Chairman Jay Clayton directed the staff to make recommendations to the Commission for possible changes to the accelerated filer definition.

How we see it

The final rule is generally consistent with the 2016 proposal. We expect stakeholders to focus their attention on the recommendations that the SEC staff will make on possible changes to the accelerated filer definition because such changes could provide an exemption from Section 404(b) of SOX for a significant number of issuers.

SEC approves rule requiring Inline XBRL

The SEC approved a rule that will require operating companies and mutual funds to use Inline XBRL and embed tags in their financial statements included in registration statements and periodic reports and their risk/return summaries, respectively. The rule requires Inline XBRL tagging of the same information operating companies and mutual funds currently include in separate XBRL exhibits. Like XBRL exhibits today, Inline XBRL data does not have to be certified by officers. Similarly, the rule does not require registrants to involve their auditors with the Inline XBRL information.

Inline XBRL requirements apply to all operating companies and mutual funds.

The Inline XBRL requirements apply to all operating companies, including emerging growth companies, smaller reporting companies and foreign private issuers (FPIs), including those that prepare their financial statements in accordance with IFRS as issued by the International Accounting Standards Board (IASB).

The transition dates are phased in for operating companies based on their filing status and for mutual funds based on their net assets.

Operating companies filing as large accelerated, accelerated and non-accelerated filers are required to comply beginning with fiscal periods ending on or after 15 June 2019, 2020 and 2021, respectively. Filers are required to comply beginning with their first Form 10-Q filed for the fiscal period ending on or after their applicable date (e.g., a calendar-year large accelerated filer must use Inline XBRL tagging in its Form 10-Q filed for the quarter ending 30 June 2019). FPIs that prepare their financial statements in accordance with IFRS as issued by the IASB are required to comply beginning with fiscal periods ending on or after 15 June 2021.

Larger mutual funds (i.e., funds with net assets of $1 billion or more as of the end of the most recent fiscal year) have to comply with the requirement two years after the rule becomes effective. Smaller mutual funds have to comply with the requirement three years after the rule becomes effective.

The rule eliminates both the requirement for operating companies and mutual funds to post XBRL data on their websites and the requirement for mutual funds to file their XBRL-tagged risk/return summaries within 15 business days. The rule will be effective 30 days after publication in the Federal Register.

SEC changes investment company liquidity disclosure requirements

The SEC adopted amendments to public liquidity-related disclosure rules for open-end funds to require the funds to discuss the operation and effectiveness of their liquidity risk management programs in their annual or semiannual shareholder report, rather than provide a quantitative end-of-period snapshot of the aggregate liquidity classification data for their portfolios on Form N-PORT.

The SEC also amended Form N-PORT to permit funds to split their portfolio holdings into more than one liquidity classification category under three specified circumstances and to require them to disclose cash and cash equivalents held that are not reported elsewhere on Form N-PORT. The amendments will be effective 10 September 2018.

SEC proposes changes for certain ETFs

The SEC proposed allowing exchange-traded funds (ETFs) organized as open-end funds that satisfy certain conditions to operate in the scope of the Investment Company Act of 1940 and come to market without applying for exemptive orders from the Commission. The proposed conditions, which are designed to protect investors, relate to transparency, custom basket policies and procedures, and website disclosures. The proposal also recommends rescinding certain exemptive relief previously granted to ETFs that would rely on the rule. The proposal would not apply to ETFs organized as unit investment trusts, ETFs structured as share classes of multi-class funds, and leveraged or inverse ETFs.

The SEC also proposed amending Form N-1A (the registration statement for ETFs organized as open-end funds) and Form N-8B-2 (the registration statement for ETFs structured as unit investment trusts) to provide more useful information to investors who purchase ETFs on an exchange.

SEC proposes changes to whistleblower rules

The SEC proposed amending its rules governing the whistleblower program created by Congress as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposal would amend the whistleblower definition in response to a recent Supreme Court decision[1] to clarify when a whistleblower would be eligible for an SEC whistleblower award, retaliation protection and heightened confidentiality protection. The proposal would also provide additional tools that the Commission could use to increase the amount of awards under $2 million and reduce the amount of awards over $30 million. The proposal would also make changes to other policies and procedures governing the program.

Original information provided by whistleblowers has led to enforcement actions in which the Commission has ordered more than $1.4 billion in financial remedies. Comments are due 60 days after the proposal is published in the Federal Register.

SEC staff focuses on ASC 606 disclosures

Comments issued by the SEC staff in the Division of Corporation Finance (DCF) to companies that early adopted Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, about their disclosures under the new standard are now public and may provide an indication of the types of comments the SEC staff is issuing to registrants that adopted the new revenue standard this year.

Identifying performance obligations

The SEC staff asked registrants questions to better understand whether all performance obligations were appropriately identified. The staff requested analyses of conclusions that certain goods or services were not separately identifiable and therefore not distinct. For example, the SEC staff has asked registrants to clarify how potential upgrades, maintenance and technical support were considered.

Recognition over time or at a point in time

The SEC staff asked registrants to further clarify the pattern of recognition for certain revenue streams, specifically how registrants determined whether revenue should be recognized over time or at a point in time. In addition, the SEC staff asked registrants that are recognizing revenue over time to clarify which recognition method they are using (i.e., input or output method) and why that measure of progress provides a faithful depiction of the transfer of goods or services.

Amortization of certain capitalized contract costs

The SEC staff asked registrants to clarify how the amortization period selected for capitalized costs to obtain a contract (e.g., sales commissions) is consistent with the transfer of goods or services to which the asset relates, and how commissions paid for contract renewals were considered in determining the amortization period. The SEC staff also asked companies to disclose the amortization period for commissions capitalized due to both initial contracts and subsequent contract renewals.

Disaggregation of revenue

The SEC staff asked registrants whether the level of disaggregation of revenue was consistent with the objective of the required disclosures (i.e., to depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors). The SEC staff also asked whether registrants' disclosures were consistent with information presented for other purposes. For example, the SEC staff issued comments when disclosures outside the financial statements or information that is regularly reviewed by the chief operating decision maker for evaluating performance of operating segments appeared to be more disaggregated than in revenue disclosures or when other information, including information in earnings releases, suggested that economic factors affected aggregated revenues differently.

The SEC staff recently said that it is monitoring the new disclosures mandated by ASC 606 and encouraging companies to refine and supplement their annual disclosures included in their quarterly filings in the year of adoption. Sagar Teotia, Deputy Chief Accountant in the Office of the Chief Accountant (OCA), recently said that the identification of performance obligations and the application of principal versus agent guidance have been the most frequently discussed topics in consultations with OCA.

The SEC staff is seeking a better understanding of judgments made by registrants applying ASC 606.

How we see it

As expected, the SEC staff's comments on the application of ASC 606 have focused on areas of judgment. However, the majority of the comments appear to have been resolved by helping the staff gain a better understanding of the judgments made by management or providing additional disclosures in future filings. Contemporaneous documentation of the judgments made in applying ASC 606 will help facilitate the dialogue with the SEC staff during the comment process.

SEC officials provide clarity on Ether and Bitcoin

Bill Hinman, Director of the SEC's DCF, said in a speech that Bitcoin transactions are not securities transactions. He added that recent transactions in Ether, the cryptocurrency used on the Ethereum network, are not securities transactions. "Based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions," Mr. Hinman said.

Mr. Hinman said that if the network on which a cryptocurrency functions is sufficiently decentralized, "the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful." He also suggested that it is possible for an instrument to cease to be a security over time. "The analysis of whether something is a security is not static and does not strictly inhere to the instrument," he said.

In the initial coin offerings (ICOs) he has seen, Mr. Hinman said that "promoters tout their ability to create an innovative application of blockchain technology, the investors are passive, the business model is still uncertain and the purchasers rely on the efforts of the promoters to build the network and make it a success." He said these transactions are subject to the federal securities laws, regardless of whether they are labeled ICOs or "token" offerings.

Mr. Hinman emphasized that the determination of whether a digital asset is a security should be based on the economic substance, and promoters and other market participants need to understand whether transactions in a particular digital asset involve the sale of a security.

He said that the SEC staff is willing to help promoters and their lawyers work through these issues and is prepared to provide more formal interpretive or no-action guidance. To respond to these market developments, the DCF named Valerie A. Szczepanik as Associate Director and Senior Advisor for Digital Assets and Innovation.

Separately, the Division of Enforcement continued its enforcement actions related to digital assets:

- The SEC halted an ICO whose organizers allegedly used fabricated testimonials from corporate customers and falsely claimed to have relationships with numerous corporate clients. The SEC staff said that the "ICO was based on a social media marketing blitz that allegedly deceived investors with purely fictional claims of business prospects."
- The SEC obtained an emergency freeze of trading proceeds from allegedly illegal distributions and sales of restricted shares of a company's stock. The complaint alleges that the chief executive and other individuals illegally sold large blocks of restricted shares shortly after the stock price rose following the company's announcement of the acquisition of a purported cryptocurrency business, which the SEC alleged had no ascertainable value, from an affiliated company.

How we see it

The appointment of a senior official dedicated to issues related to digital assets indicates that the SEC intends to continue focusing on this topic. We expect this will lead to the issuance of more interpretive guidance on digital assets.

Other SEC rulemaking and implementation

SEC modernizes delivery of fund reports, seeks comments on processing fees

The SEC adopted a rule that allows funds to satisfy their obligations to transmit shareholder reports by making them publicly accessible on a specified website, free of charge, and mailing investors a paper notice of the report's availability. Investors who prefer to receive hard copies of the reports may choose that option at any time. Funds may rely on the new rule, known as Rule 30e-3 under the Investment Company Act of 1940, as early as 1 January 2021. Funds will generally be required to provide two years' notice to shareholders if they wish to rely on the rule in the first year it is effective (i.e., 2021).

In response to questions raised in connection with the Rule 30e-3 proposal, the SEC is requesting comments on the assessment and transparency of the processing fees that broker-dealers and other intermediaries charge funds for delivering shareholder reports and other materials to beneficial shareholders under the rules of the New York Stock Exchange and other self-regulatory organizations. Comments are due by 31 October 2018.

SEC seeks comments on how to enhance fund disclosures

The SEC is seeking public comment on the design, delivery and content of fund disclosures such as shareholder reports, prospectuses and advertising and how technology can be used to make these communications more interactive. Comments are due by 31 October 2018.

SEC proposes amending its auditor independence rules

The SEC proposed amending its auditor independence rules to refocus the analysis that must be conducted to determine whether an auditor is independent if it has a borrowing relationship with certain shareholders of an audit client. In the proposal, the SEC said that

existing restrictions may not be functioning as intended and may present significant practical challenges to companies, including registered investment companies, pooled investment vehicles and registered investment advisers, and their auditors.

The proposed amendments to Rule 2-01(c)(1)(ii)(A) of Regulation S-X would:

- Focus the analysis solely on beneficial ownership rather than record or beneficial ownership
- Replace the existing 10% bright-line shareholder ownership test with a "significant influence" test
- Add a "known through reasonable inquiry" standard to identify beneficial owners of the audit client's equity securities
- Amend the definition of "audit client" for a fund under audit to exclude funds that otherwise would be considered "affiliates of the audit client"

The SEC also requested comments on other proposed changes to its auditor independence rules. Due to the concerns discussed in the proposal, the SEC staff provided relief through a 2017 no-action letter pending this proposed rulemaking.

SEC seeks comments on draft five-year strategic plan

The SEC is seeking comments on a draft of its five-year strategic plan. The plan outlines three goals: (1) focus on the long-term interest of Main Street investors, (2) recognize significant developments and trends in the capital markets and adjust the Commission's efforts to make sure it is effectively allocating resources, and (3) elevate the SEC's performance by enhancing its analytical capabilities and human capital development.

Comments on the plan can be submitted to performanceplanning@sec.gov.

Updates to SEC staff guidance

'Bedbug' letters are now published on EDGAR

The SEC staff in the DCF announced that it will make letters about serious deficiencies in filings, informally known as "bedbug" letters, available on EDGAR 10 days after their issuance, starting with those issued on or after 15 June 2018. The SEC staff sends bedbug letters to issuers to inform them that a registration statement or offering document is so deficient that the SEC staff is deferring its review of the filing until it is amended to resolve the deficiencies. The SEC staff said publishing the letters is consistent with its efforts to enhance the transparency of its review process.

Other SEC activities

CAQ SEC Regulations Committee meeting

The Center for Audit Quality (CAQ) SEC Regulations Committee issued highlights of its March 2018 meeting at which the SEC staff expressed the following views:

- A company submitting a draft initial public offering (IPO) registration statement may assess the significance under Rule 1-02(w) of Regulation S-X of an acquisition that takes place after year end based on the financial statements of the most recently completed fiscal year, as long as audited financial statements for that period will be included when its IPO registration statement is first publicly filed.
- A nonpublic accounting acquirer in a reverse merger transaction with a public operating company is considered an issuer when its financial statements covering pre-acquisition periods are reissued after the consummation of the merger (i.e., upon filing the first periodic report on Form 10-Q or Form 10-K for a period that includes the consummation date).

The SEC staff also reiterated the following views:

- Registrants may exclude one-time effects of the Tax Cuts and Jobs Act when presenting their non-GAAP financial measures, but when they do, they should exclude all of the one-time effects and may not cherry-pick certain adjustments. Further, registrants should not apply the new lower tax rates when calculating non-GAAP financial measures for periods before the enactment date.
- Registrants that have adopted ASC 606 using the modified retrospective approach may provide supplemental information using ASC 606 for comparable periods in management's discussion and analysis (MD&A). Those registrants are also permitted to present 2018 financial results under ASC 605 as supplemental information in MD&A during the year of adoption. However, in both circumstances, the SEC staff cautioned that the supplemental information in MD&A should not be more prominent than the historical information, and the supplemental information should be limited to those line items affected by the new revenue standard.

Current practice matters

Financial restatements hit a 17-year low

The number of restatements of previously issued financial statements has steadily decreased in recent years and hit a 17-year low in 2017, according to research firm Audit Analytics. Out of the 553 restatements that SEC registrants reported in 2017, 109 involved reissuances of prior-year financial statements, known as "Big R" restatements. This is also the lowest number of Big R restatements since registrants were required to report them on Form 8-K in August 2004. The accounting areas with the most restatements continued to include debt and equity, revenue recognition, income taxes and cash flows statement classification.[2]

The Commission's rulemaking activity may decrease until Mr. Piwowar's successor is sworn in.

Personnel changes

Roisman nominated to succeed Piwowar as SEC Commissioner

President Donald Trump nominated Elad Roisman to serve as an SEC Commissioner. If confirmed by the US Senate, Mr. Roisman would succeed Mr. Piwowar. Mr. Roisman, a Republican, is currently Chief Counsel to the Senate Committee on Banking, Housing and Urban Affairs. He also served as counsel to former SEC Commissioner Daniel Gallagher, focusing on trading and markets issues. While Mr. Roisman's confirmation hearing before the Senate Committee on Banking, Housing and Urban Affairs is scheduled for 24 July 2018, the timing of when the Commission will be back to a full slate of five Commissioners is uncertain.

SEC announces appointments

The Commission named Julie A. Erhardt as Acting Chief Risk Officer of the Commission. She was previously a Deputy Chief Accountant in the OCA. The SEC also named Dr. Chyhe Kim Becker as Acting Chief Economist and Acting Director of the Division of Economic and Risk Analysis, where she has served as an Associate Director since 2015.

Enforcement activities

Electronics company charged with anti-bribery and accounting fraud violations

An electronics company agreed to settle charges that it violated the anti-bribery, anti-fraud, books and records and internal accounting controls provisions of the federal securities laws.

The SEC found that the company:

- Provided a consulting position to a government official at a state-owned airline in 2007 to induce the official to help the company obtain and retain business from the airline
- Overstated its pretax income and net income by backdating an agreement with the airline, prematurely recognizing revenue and providing misleading information to its auditor
- Failed to implement appropriate internal controls and to make and keep accurate records about the company's use of consultants and sales agents

The company agreed to pay $143 million in disgorgement and prejudgment interests. In a related matter, the company entered into a deferred prosecution agreement with the US Department of Justice related to violations of the accounting provisions of the Foreign Corrupt Practices Act. In that agreement, the company acknowledged responsibility for conduct relating to the SEC findings and agreed to pay a criminal penalty of $137 million.

Internet company charged with failing to disclose material cybersecurity breach

An internet media company agreed to settle charges that it misled investors by failing to timely disclose a massive cybersecurity breach. The SEC alleged that the company failed to disclose the breach in any public filings until almost two years after it happened, despite senior management's alleged knowledge that the breach had occurred. As a result, the SEC found that the company failed to file periodic and current reports with the Commission that contained material information that may have been necessary so the reports would not be misleading and to maintain disclosure controls and procedures designed to ensure that cybersecurity breaches, or the risk of such breaches, were properly and timely assessed for potential disclosure. The company agreed to pay a $35 million civil penalty.

What's next at the SEC?

Following a flurry of SEC rulemaking activity in June, we may see a decrease in activity until Mr. Piwowar's replacement is sworn in. After the SEC is back to a full slate of commissioners, we expect it to finalize certain proposals, such as the proposed Disclosure Update and Simplification, and propose additional disclosure rules.

We also expect the SEC staff to continue issuing comments on the application of Staff Accounting Bulletin 118 and the adoption of the revenue standard. In addition, we expect the SEC staff to increase its focus on transition disclosures related to the new leases standard.

Endnotes:

1 *Digital Realty Trust, Inc. v. Somers*.

2 Audit Analytics publication, *2017 Financial Restatements: A Seventeen Year Comparison*, June 2018.