Issue 1, January 2019

SEC in Focus

Quarterly summary of current SEC activities

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SEC focuses on disclosures on new standards, emerging risks

Officials of the Securities and Exchange Commission (SEC or Commission) said at the annual AICPA Conference on Current SEC and PCAOB Developments in Washington, D.C. last month that they expect registrants' disclosures to evolve over time to reflect the effects of new accounting standards and emerging market risks.

SEC staff members shared their views on a broad range of financial reporting topics and issues, including the application of new accounting standards, the financial reporting effects of emerging risks and uncertainties (e.g., Brexit, transition from the London Interbank Offered Rate (LIBOR), cybersecurity), and the use of non-GAAP financial measures. SEC Chairman Jay Clayton also reiterated his strategic priority to foster capital formation in the US capital markets through rulemaking intended to eliminate burdensome financial reporting requirements that do not contribute materially to the information provided to investors.

Revenue recognition

SEC staff members said their comments to registrants on their application of Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers,* have focused on areas of significant judgment, such as the identification of performance obligations and the timing of revenue recognition. The staff encouraged companies to continue to improve and refine their disclosures based on their increasing experience with the standard and disclosures provided by their peers.

While the staff said it is premature to highlight any trends, it will continue to review registrants' application of the new revenue standard and their disclosures. The staff said it will also question registrants when it suspects that they are not complying with the standard or they are omitting material disclosures. When responding to SEC staff comments, registrants should consider and address materiality if the revenue streams on which the staff is commenting are not material.

Building a better working world

EY resources

- *Compendium of significant accounting and reporting issues, 2018 AICPA Conference on Current SEC and PCAOB Developments (SCORE No. 05162-181US)*

How we see it

So far, registrants appear to be resolving the majority of the comments on ASC 606 by providing more information to help the staff gain a better understanding of the judgments made by management and, in certain cases, providing additional disclosures in future filings.

We encourage companies to continue to improve their revenue disclosures in their year-end filings and to keep contemporaneous documentation of the significant judgments they make in applying the new standard to facilitate dialogue with the SEC staff during the comment process.

Non-GAAP financial measures

The SEC staff said using non-GAAP financial measures can help management tell its story and encouraged companies to provide transparent and robust disclosures about why the measures are useful to investors. The staff also addressed how to evaluate whether non-GAAP financial measures involve individually tailored accounting principles that may be inappropriate under Regulation G. In addition, the staff emphasized the importance of having disclosure controls and procedures to make sure non-GAAP disclosures are not misleading.

Companies should consider whether their disclosures under the new revenue standard need to be improved or refined compared with their initial disclosures.

Cybersecurity

The SEC staff reminded registrants to provide company-specific cyber disclosures. Staff members also stressed the importance of disclosing how the board of directors oversees cyber risks and the company's controls and procedures so that information about significant cyber incidents is communicated to those in management with responsibility for public disclosures. The SEC staff is expected to focus on cybersecurity disclosures in its reviews of public company annual reports and proxy statements.

Quarterly reporting requirements

The SEC 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 is seeking to understand current reporting practices, including the relationship between quarterly reports that companies must file with the SEC and voluntary earnings releases they issue. "There is an ongoing debate regarding the effects of mandated quarterly reports and the prevalence of optional quarterly guidance," SEC Chairman Clayton said. Among other things, the SEC is seeking comment on whether:

- A company should be allowed to use the information it voluntarily provides in earnings releases to satisfy the requirements of Form 10-Q
- The Commission should require semiannual reporting or allow companies to select the frequency of their interim reporting, based on their investors' needs
- The practice of voluntarily providing forward-looking guidance creates an undue focus on short-term decision-making and what actions, if any, the Commission should take to discourage this practice

Comments are due by 21 March 2019.

EY resources

- To the Point, *SEC seeks input on earnings releases and quarterly reports (SCORE No. 05316-181US)*
- To the Point, *Renewed focus on quarterly reporting (SCORE No. 04485-181US)*

How we see it

We support quarterly reporting because it gives investors access to timely and decision-useful information. However, we have previously recommended that the SEC allow less frequent interim reporting in limited circumstances (i.e., smaller reporting companies that are not listed on a national exchange).

We encourage companies to provide feedback on this important topic and suggest ways to make interim reporting more efficient and effective. We also encourage investors and other stakeholders to evaluate the interim information they receive and reflect on whether and how it could be improved.

Final rule on implementing Dodd-Frank requirements to disclose employee and director hedging policies

A new rule implementing Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires companies to disclose any practices or policies regarding the ability of employees (including officers) or directors to engage in transactions that hedge or offset any decrease in the market value of the company's equity securities or those of certain related entities.

Registrants that do not have such policies or practices must disclose that fact or state that hedging transactions are generally permitted. The rule applies to all equity securities held by employees, officers and directors, directly or indirectly, not just equity securities granted as compensation. Registrants must provide the disclosures in proxy or information statements related to the election of directors.

Registrants other than smaller reporting companies (SRCs) and emerging growth companies (EGCs) must provide the disclosures during fiscal years beginning on or after 1 July 2019. SRCs and EGCs must provide the disclosures during fiscal years beginning on or after 1 July 2020. Listed closed-end funds and foreign private issuers are not subject to the rule.

Other SEC rulemaking and implementation

Final rules expand availability of Regulation A exemptions

The SEC adopted final rules that allow Securities Exchange Act (Exchange Act) reporting companies to use the Regulation A exemptions for securities offerings of up to $50 million within a 12-month period. The new rules will also permit Exchange Act reporting companies to use their Exchange Act reports to satisfy their ongoing reporting obligations under Tier 2 of Regulation A. The rules are expected to give public companies more flexibility to raise capital. They were mandated by the Economic Growth, Regulatory Relief, and Consumer Protection Act and will be effective upon publication in the Federal Register.

New rule modernizes mining company disclosures

The SEC adopted a rule to modernize the property disclosure requirements for mining registrants. The rule rescinds Industry Guide 7 and incorporates the mining property disclosure requirements in Regulation S-K. The rule will more closely align the SEC's mining property disclosure requirements with current industry and global regulatory practices and standards.

Under the new rule, in addition to information about mineral reserves for properties that are individually material, mining registrants will have to provide a summary about mineral resources and material exploration results for groups of properties that may be individually immaterial but material in the aggregate. The disclosures will have to include support from a mining technical expert and describe the registrant's internal controls over the reliability of its property disclosures and estimates.

The new disclosure requirements will apply to any domestic or foreign registrant (other than certain Canadian issuers) with mining operations that are material to its business or financial condition. Registrants must begin providing the new disclosures in fiscal years beginning on or after 1 January 2021. Early adoption is permitted.

Other SEC activities

SEC highlights securities laws on the issuance and trading of digital assets

The SEC's divisions of Corporation Finance, Investment Management, and Trading and Markets issued a joint statement expressing their views on issues raised in recent Commission enforcement actions involving the issuance and trading of digital assets that meet the definition of a security.

The statement highlights the importance of complying with federal securities laws in the following areas:

- Initial offers and sales of digital assets that are considered securities — The divisions stressed the importance of determining whether a digital asset is a "security" for purposes of the federal securities laws and, if it is, determining which registration requirements apply. Shortly before the statement was released, two companies agreed to settle charges that they used unregistered initial coin offerings (ICOs) to improperly offer tokens that qualified as securities.
- Investment vehicles investing in digital assets that are considered securities — Investment vehicles that hold digital assets that are considered securities, as well as individuals who advise others about investing in digital assets that meet the definition of a security, including managers of investment vehicles, are subject to the registration, regulatory and fiduciary obligations of the Investment Company Act of 1940.
- Exchange registration — A platform that offers trading in digital assets meeting the definition of a security and that operates as an exchange must register with the SEC as a national securities exchange or be exempt from registration (e.g., by qualifying as an alternative trading system (ATS) under Regulation ATS). The statement clarifies that the activity that actually occurs between the buyers and sellers, not the kind of technology or the terminology used by the entity, determines whether the platform is a national securities exchange.
- Broker-dealer registration — Entities that facilitate ICOs and secondary trading of digital assets that are considered securities may also be acting as brokers or dealers and thus are required to register with the SEC and become a member of a self-regulatory organization, typically the Financial Industry Regulatory Authority.

The SEC staff warns companies to make sure they comply with all federal securities laws involving digital assets.

The divisions encouraged entities that use new technologies in the US securities markets to consult with legal counsel, as well as the SEC staff, as necessary, to make sure they comply with the federal securities laws.

How we see it

The SEC has emphasized that it will continue to place significant focus on digital asset compliance matters in 2019. Affected companies should make sure they are dedicating sufficient resources to assessing and complying with all related requirements.

Current practice matters

SEC operating with limited staff during the government shutdown

The SEC has been operating with very limited staff during the government shutdown. Limited staff is available to respond to emergency situations involving market integrity and investor protection, including those involving the protection of property. The SEC's EDGAR system will continue to accept registration statements, offering statements and other filings; however, the staff will not be able to review filings and declare registration statements effective. In addition, the staff in the Divisions of Corporation Finance and Investment Management will not be able to provide interpretive advice or respond to any waiver, no-action or preclearance requests that would be normal activities. Companies seeking to register their public offerings with the Commission should plan accordingly and continue to monitor the SEC's operating status.

EY resources

- To the Point, *SEC highlights the need for companies to focus on controls that prevent cyber-related fraud* (SCORE No. 04815-181US)

Companies need to focus on controls that prevent cyber-related fraud

The SEC issued a report that highlights the need for all companies to focus on their procedures and internal controls over the authorization of transfers of cash, given the growing trend of frauds perpetrated using emails to obtain inappropriate payments.

The Commission issued the report to make companies aware that cyber-related threats exist from spoofed or manipulated electronic communications and should be considered when a company devises and maintains a system of internal accounting controls, as required by the federal securities laws. The Commission cited a recent estimate from the Federal Bureau of Investigation that these so-called "business email compromises" had caused more than $5 billion in losses since 2013.

The report is the result of an SEC investigation into whether nine companies that lost a total of nearly $100 million in cyber-related frauds involving spoofed or otherwise compromised electronic communications violated the securities laws by failing to have a sufficient system of internal accounting controls. The Commission decided not to pursue enforcement actions against the companies.

The frauds were not sophisticated in design or the use of technology. Instead, the SEC said, they used technology to exploit weaknesses in policies and procedures and human vulnerabilities that rendered the controls related to payments ineffective. Many of the frauds were enabled by human actions (or lack of actions) and weaknesses in controls at companies in a range of industries.

Companies need to reconsider their policies, procedures and related controls to make sure they consider the possibility that electronic communications may be spoofed or manipulated. This means determining whether emails can be accepted as authorization to enter into transactions without additional verification or authentication.

How we see it

The pervasive use of electronic forms of communications and the general expectation that such communications are trustworthy creates risks for companies that need to be considered. Registrants may need to revisit their controls related to the authorization of the transfer of funds and changes to vendor master file data and their training for employees. Registrants should also consider the implications of any related deficiencies on their internal control over financial reporting (ICFR).

EY resources

- Technical Line, *Accounting and reporting considerations for Brexit* (SCORE No. 04678-181US)
- Technical Line, *2018 year-end accounting and disclosure reminders* (SCORE No. 05247-181US)

SEC staff will monitor registrants' Brexit and LIBOR disclosures

With the United Kingdom (UK) expected to withdraw from the European Union (EU) (i.e., Brexit) in March 2019, Chairman Clayton and the SEC staff have said they will focus on disclosures of company-specific risks associated with Brexit.

Registrants with operations and/or investments in the UK and the EU need to monitor developments and consider the accounting and financial reporting implications of the uncertainty related to Brexit, including the possibility that there may not be a final agreement in place by the deadline. William Hinman, the Director of the SEC's Division of Corporation Finance, said his staff has reviewed a sample of 100 companies' Brexit-related disclosures, which ranged from a single bullet item in the list of international operations' risk factors to more thoughtful and company-specific disclosures that would be helpful for investors.

The SEC staff has said that it expects companies to expand disclosures about the potential effects of Brexit on matters such as taxes, assets, financing and business operations, where material. Additional disclosures may be necessary in the notes to the financial statements or in other parts (e.g., management's discussion and analysis) of a registrant's next periodic report (annual or quarterly) to describe implications to foreign operations that are materially affected by these developments, including the following:

- Risks disclosures — A registrant should consider whether there have been material changes in its previously disclosed risk factors related to Brexit or whether the company is exposed to any new risk factors. These disclosures should be tailored to the registrant's facts and circumstances, including discussing the registrant's affected foreign operations and the specific effects on those operations and its liquidity and financial condition.
- Known trends or uncertainties[1] — Although the effects of Brexit may be difficult to predict with precision, a registrant should consider whether to disclose forward-looking information about reasonably likely effects on matters such as income taxes, financing and operations.
- Critical accounting estimates — Registrants should consider whether to make additional quantitative and qualitative disclosures to describe uncertainty associated with fair value estimates related to impairments of investments, goodwill and other assets (e.g., effects of Brexit on assumptions and related sensitivities to goodwill impairment).

Likewise, the SEC staff said it has started to review disclosures in connection with the planned phaseout of LIBOR to see whether registrants describe the types of backstop arrangements that may be in place if LIBOR is no longer quoted, noting that it expects registrants to start thinking through potential effects and making more detailed disclosures. The staff expects registrants to provide disclosures about the effects of the LIBOR phaseout if the effects are material to items such as liquidity, debt covenant compliance and hedge accounting. In each of these cases, the disclosures should evolve as companies learn more about the likelihood and materiality of the effects.

In 2018, the SEC's whistleblower program received 5,200 tips and awarded more than $168 million to whistleblowers.

Enforcement activities

Record-breaking year for SEC's whistleblower program

In the fiscal year ended 30 September 2018, the SEC's whistleblower program received 5,200 tips and awarded more than $168 million to 13 individual whistleblowers. This amount exceeded the total amount awarded in all prior years combined "and reflects the significance of the information that whistleblowers are reporting to the Commission," Chief of the Office of the Whistleblower Jane Norberg said.

The SEC has proposed amendments to the whistleblower rules that would clarify the requirements for anti-retaliation protection and provide the SEC additional flexibility in scaling payments to incentivize whistleblowers.

Organic food company charged with internal controls failures

A natural and organic food company settled charges related to weaknesses in its internal controls related to sales practices aimed at helping the company meet its internal sales targets.

Company sales personnel offered certain of its distributors incentives at the end of fiscal quarters to encourage purchases to meet internal sales targets. The incentives were agreed to orally or documented only in email exchanges with the distributors. When the company's finance department discovered these practices, the company self-reported the discovery to the SEC and announced it was delaying its financial reporting.

The SEC's order found that the company lacked sufficient policies and procedures to make sure the incentives were properly documented and accounted for. The SEC did not impose a monetary penalty, taking into account the company's timely self-reporting, its cooperation during the investigation and the significant changes it voluntarily made to its organization and to its revenue recognition practices. The company agreed to the SEC's order without admitting or denying the findings.

Agricultural company and executive chairman charged with fraud

A multinational agricultural company agreed to settle charges that it concealed substantial losses from investors when it sold its Chinese operating entity in return for stock and land use rights to undeveloped land in a remote area of China. According to the order, the company overstated the value of the stock it received by $17 million and assigned a value of nearly $60 million to the substantially worthless land use rights.

In a related action, the company's executive chairman settled charges that he manipulated the company's share price by engaging in manipulative trading in the company's American Depositary Shares to inflate their price and prevent the securities from being delisted by the New York Stock Exchange.

Without admitting or denying the findings, the company agreed to pay a $3 million penalty, and the executive chairman agreed to pay a $400,000 penalty and be barred for a period of five years from acting as an officer or a director of any public company.

Security company violates requirements for non-GAAP financial measures

A provider of commercial and residential security and automation services agreed to settle charges that it provided non-GAAP financial measures such as adjusted earnings before interest, taxes, depreciation and amortization, adjusted net income and free cash flow before special items without giving equal or greater prominence to the comparable US GAAP financial measures.

According to the order, the noncompliant disclosures were presented in the earnings releases for the company's fiscal year ended 31 December 2017 and first quarter of fiscal year 2018. Without admitting or denying the findings, the company agreed to pay a $100,000 fine.

Cryptocurrency-related enforcement activities

The SEC recently brought several enforcement actions related to digital assets, which addressed a variety of emerging issues, including:

- Fraudulent ICO falsely claiming SEC approval — The SEC obtained an emergency court order halting a planned ICO that a company and its founder falsely claimed was approved by the Commission.
- Operating an unregistered exchange — The founder of a digital token trading platform settled charges that he operated an unregistered national securities exchange.

- Failure to register ICOs under federal securities laws — Two companies settled charges that they failed to register their ICOs as securities offerings. These were the Commission's first cases imposing civil penalties solely for securities registration violations by an ICO.
- The unlawful touting of ICOs — Two celebrities settled charges for failing to disclose payments they received for promoting investments in ICOs.

In addition, the SEC issued an alert warning investors to be vigilant for false claims about SEC compliance and endorsements used to promote digital asset investments. The Commission said that it does not endorse investment products or investment custodians, and in a related enforcement action noted that "investors should be highly skeptical of any claims suggesting otherwise."

What's next at the SEC?

Chairman Clayton has said that in 2019 the SEC will focus on rulemaking relating to the conduct of financial professionals, improving the proxy process and facilitating capital formation. The SEC staff is working on a concept release on the private offering framework and how it can be improved, harmonized and streamlined.

The Division of Corporation Finance (Division) is considering whether to propose amendments to the "accelerated filer" definition in the Exchange Act rules, which would reduce the number of registrants that are subject to the ICFR attestation requirement under Section 404(b) of the Sarbanes-Oxley Act. The Division is also considering whether to recommend the SEC propose amendments to Rule 3-05 of Regulation S-X that would affect the disclosure of financial information about acquired businesses, including pro forma financial information.

The SEC also expects to continue its focus on distributed ledger technology, digital assets and ICOs. This will include further development of its new Strategic Hub for Innovation and Financial Technology, or FinHub, as a central resource for financial technology-related issues and the SEC's initiatives in this area.

Endnote:

[1] Item 303 of Regulation S-K states that a registrant is required to provide forward-looking information about known trends and uncertainties that have had, or are reasonably likely to have, a material effect on the registrant's revenues or income from continuing operations, liquidity or capital resources.