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SEC in Focus

Quarterly summary of current SEC activities

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Progress on SEC's regulatory agenda

Securities and Exchange Commission (SEC or Commission) Chairman Gary Gensler continues to focus on company disclosures and investor protection.

In his **testimony** at a recent Senate Banking Committee hearing, Mr. Gensler noted that investors are looking for consistent, comparable and decision-useful disclosures about climate risk, human capital and cybersecurity. He also noted that the SEC is focusing on investments in special purpose acquisition companies (SPACs), issues related to certain Chinese companies that raise capital in securities offerings in the US, and gaps in the existing insider trading regime. "Companies and investors alike would benefit from clear rules of the road. I believe the SEC should step in when there's this level of demand for information relevant to investors' investment decisions," Mr. Gensler said.

ESG update

In a recent **speech**, Mr. Gensler described the environmental, social and governance (ESG) factors he has asked the SEC staff to consider in developing a proposal to require climate risk disclosures, including the location of the disclosures, the need for industry-specific metrics, and a variety of qualitative and quantitative information about climate risk.

Mr. Gensler said he has asked the staff to make recommendations about how companies might disclose their greenhouse gas emissions from their operations (known as Scope 1 emissions in the widely used Greenhouse Gas Protocol) and the emissions from their purchases of energy (known as Scope 2 emissions). He said he also has asked the staff to make recommendations about whether companies should be required to disclose Scope 3 emissions (i.e., other emissions related to their value chain, including transportation) and what data or metrics companies might use to inform investors about their progress toward their environmental goals.

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In addition, Mr. Gensler said that, while he has asked the staff to consider the work done by various standard setters (e.g., the Task Force on Climate-related Financial Disclosures), he believes that the SEC should move forward to write rules and establish climate risk disclosure requirements that are appropriate for the US markets.

Separately, the SEC's Division of Corporation Finance (DCF) posted a sample **comment letter** on its website to illustrate the types of comments it may issue to companies regarding their compliance with the SEC's **2010 guidance on climate-related disclosures.**

In posting the letter, the SEC staff reminded registrants that the 2010 guidance addresses disclosures about the impact of pending or existing climate change-related legislation, regulations and international accords; the indirect consequences of regulation or business trends; and the physical impacts of climate change. The sample comment letter indicates that the staff may also ask how registrants have considered whether to disclose the material effects of risks related to changes to their business that may be necessary to respond to climate risk. It also indicates that the SEC staff may ask registrants how they considered whether the information they included voluntarily in their sustainability or corporate responsibility reports should also be included in their annual reports filed with the SEC.

"I believe it's with mandatory disclosures that investors can benefit from that consistency and comparability. When disclosures remain voluntary, it can lead to a wide range of inconsistent disclosures.

— SEC Chair Gary Gensler

We understand that the SEC staff has already begun issuing comment letters to registrants on these topics. For more information on how to apply the SEC's 2010 guidance, refer to our Technical Line, ***Revisiting the SEC's guidance on climate change disclosures in today's environment***.

How we see it

We expect the DCF staff to continue to address issuers' climate-related disclosures through the comment process, even while rulemaking on this topic is underway. We urge registrants to consider the 2010 guidance and to continue to reevaluate their disclosures as their businesses evolve.

Investor protection related to developments in China

Mr. Gensler issued a **statement** calling for additional disclosures by certain Chinese companies that raise capital in securities offerings in the US. The statement primarily focuses on the variable interest entity (VIE) structure commonly used by Chinese operating companies that establish offshore shell companies (e.g., in the Cayman Islands) to issue stock to public shareholders. In such an arrangement, the shell company consolidates the Chinese operating company, or VIE, due to a contractual arrangement rather than an equity ownership interest.

Mr. Gensler asked the SEC staff to seek the following disclosures from these offshore issuers before their registration statements will be declared effective:

- A statement that investors are not buying shares directly in the China-based operating company but rather are buying shares of the shell company that maintains contractual relationships with the China-based operating company
- A statement that the China-based operating company, the shell company issuer and investors face uncertainty about future Chinese government actions that could significantly affect financial performance and enforceability of the contractual arrangements
- Detailed financial information on the financial relationship between the shell company and the VIE

Mr. Gensler also called for all China-based companies seeking to register securities (either directly or through the use of a VIE structure) to disclose (1) whether the operating company or the shell company was denied permission from Chinese authorities to sell shares on US exchanges and (2) the potential for future delisting under the Holding Foreign Companies Accountable Act (HFCAA) if the Public Company Accounting Oversight Board (PCAOB or Board) is unable to inspect the issuer's public accounting firm.

The PCAOB has adopted a **rule** that would establish a framework for the Board to use to make determinations under the HFCAA. The HFCAA requires the Board to determine whether it is unable to completely inspect or investigate registered public accounting firms located in a foreign jurisdiction because of a position taken by one or more authorities in that jurisdiction. The rule describes factors the PCAOB would evaluate and the documents and information the Board would consider when assessing whether a determination is warranted; the form, public availability, effective date and duration of such determinations; and the process the Board would use to reaffirm, modify or vacate any determinations. Like other PCAOB rules, the rule requires the approval of the SEC, which is accepting public comments until 19 October 2021.

SPAC transactions

Mr. Gensler said in recent prepared remarks at a meeting of the SEC's Investor Advisory Committee (IAC) that he has asked the SEC staff to look closely at each stage of the SPAC process to make sure that all investors are being protected. This includes developing rulemaking recommendations to elicit enhanced disclosures and conducting economic analysis to better understand how SPAC transactions may benefit or harm investors. The IAC has unanimously approved **recommendations** that the SEC take further actions to address SPAC regulatory and investor protection issues. The recommendations call for stricter enforcement of existing disclosure rules under the Securities Exchange Act of 1934 related to the adequacy of SPACs' disclosures in several areas (e.g., the role of the SPAC sponsor, potential conflicts of interest, the difference between the sponsor's financial interest and that of the retail investors in the SPAC).

Other SEC rulemaking and current practice matters

SEC approves new Nasdaq listing rules related to board diversity

The SEC **approved** Nasdaq Stock Market LLC rules that require all listed companies to meet certain minimum diversity targets or disclose why they aren't doing so.

Most Nasdaq-listed companies will be required to have, or explain why they do not have, at least two diverse board members, including one director who self-identifies as female and one director who self identifies as either an underrepresented minority or lesbian, gay, bisexual, transgender, queer or other (LGBTQ+). Companies with five or fewer board members need to have one diverse board member to meet the target. Underrepresented minorities are defined as individuals who self-identify as one or more of the following groups: Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, or two or more races or ethnicities.

All listed companies must also provide statistical information about the diversity of their boards by the later of 6 August 2022 or the filing date of their proxy statement or information statement for their annual shareholders meeting (or the date they file their Form 10-K or Form 20-F if they do not file a proxy or information statement) in 2022.

Under the rules' transition provision, all listed companies must have one diverse director (or explain why they don't) by the later of 6 August 2023 or the date they file their proxy statement or their information statement for their annual shareholders meeting (or the date they file their Form 10-K or Form 20-F if they do not file a proxy or information statement) in 2023.

Companies with six or more board members must have two diverse directors (or explain why they don't) no later than (1) 6 August 2025 if they are listed on the Nasdaq Global Select or Nasdaq Global Market tiers or (2) 6 August 2026 if they are listed on the Nasdaq Capital Market tier.

EY resources

- ***SEC Reporting Update: highlights of trends in 2021 SEC comment letters***
- *To the Point,* ***SEC eliminates certain MD&A requirements and revises others to make disclosures more useful***

Trends in 2021 SEC staff comment letters

The topics the SEC staff addressed most frequently in comment letters for the year ended 30 June 2021 were non-GAAP financial measures, management's discussion and analysis (MD&A), and segment reporting. In our review of SEC staff comment letters on periodic reports, we also found that the volume of SEC staff comment letters continued to decline and was down 20% from the previous year.

During the year, the SEC staff issued a number of comments addressing disclosures about the COVID-19 pandemic. They focused on the specificity of a company's disclosures of risk factors and the effects of the pandemic in MD&A, fair value measurements and non-GAAP financial measures. Our ***SEC Reporting Update: highlights of trends in 2021 SEC comment letters*** provides examples of the SEC staff's comments, including topics of frequent comment that companies planning to go public through an initial public offering or merger with a SPAC should consider when preparing their initial registration statements and subsequent filings.

Mandatory compliance date for recent SEC amendments to Regulation S-K

As a reminder, the mandatory compliance date for the SEC's **amendments** to Regulation S-K was 9 August 2021. The amendments add objectives to the requirements for MD&A and change or clarify the requirements for a number of items such as liquidity and capital resources, known trends and uncertainties, critical accounting estimates, and off-balance sheet arrangements.

Registrants are required to apply the amended rules for fiscal years ending on or after the mandatory compliance date. Registrants must also apply the amended rules in a registration statement and prospectus that on its initial filing date is required to contain financial statements for a period on or after the mandatory compliance date.

SEC proposes changes to enhance reporting of proxy votes by registered investment companies

The SEC **proposed** changes to Form N-PX under the Investment Company Act of 1940 to enhance the information mutual funds, exchange-traded funds and certain other funds report annually about their proxy votes. Key changes include requiring funds to tie the description of the voting matter to the issuer's form of proxy, to categorize voting matters by type, and to disclose the number of shares that were voted (or, if not known, the number of shares that were instructed to be cast) and the number of shares that were loaned and not recalled.

The SEC also proposed rule and form amendments under the Securities Exchange Act of 1934 (Exchange Act) that would require an institutional investment manager subject to Section 13(f) of the Exchange Act to report annually on Form N-PX how it voted proxies relating to executive compensation matters, as required by Section 14A of the Exchange Act. The proposed reporting requirements for institutional investment managers, if adopted, would complete implementation of Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Public comments are due 60 days after publication in the Federal Register.

Personnel changes

Gerding named Deputy Director of DCF, Berkovitz named General Counsel

Erik Gerding was named Deputy Director, Legal and Regulatory Policy, of the SEC's DCF. He has been a professor of law at the University of Colorado Law School, with a focus on corporate and securities law and financial regulation. He previously practiced in the New York and Washington, DC, offices of Cleary Gottlieb Steen & Hamilton LLP, representing clients in the financial services and technology industries in an array of financial transactions and regulatory matters.

Dan Berkovitz was named SEC General Counsel. He has served as a Commissioner of the Commodity Futures Trading Commission since September 2018. He previously was a partner at the law firm of WilmerHale. He also was an adjunct professor at Georgetown University Law School and vice-chair of the American Bar Association Committee on Derivatives and Futures Law. John Coates, who has been serving as the SEC General Counsel since June, will leave the agency in October and return to teaching at Harvard Law School.

> "Today's settlement will deter future misconduct in the SPAC market without inhibiting capital formation, while also allowing for the distribution of monetary relief to harmed investors.
>
> —Melissa R. Hodgman, then Acting Director of the SEC Division of Enforcement

Enforcement activities

SEC charges SPAC, sponsor, merger target and CEOs for misleading disclosures

The SEC settled charges against a SPAC, its sponsor, its proposed merger target and the chief executive officer (CEO) of the SPAC for making misleading claims about the target company's space transportation technology and about national security risks associated with the founder and former CEO of the target company. The SEC also filed charges against the target company's former CEO in federal court in Washington, DC.

According to the SEC's order, the target company and its former CEO had repeatedly misrepresented the failing test results of its technology, the technology's commercial viability and the extent to which national security concerns involving the former CEO undermined the target company's ability to secure required governmental licenses that are essential to its operations. In addition, the order finds that the SPAC has repeated the target company's misleading statements in public filings and failed its due diligence obligations to investors.

Without admitting or denying the SEC's findings, the target company, the SPAC and the SPAC's CEO agreed to pay civil penalties of $7 million, $1 million and $40,000, respectively. The SPAC and target company have also agreed to provide private-investment-in-public-equity investors with the right to terminate their subscription agreements prior to the shareholder vote to approve the merger. The SPAC's sponsor has agreed to forfeit 250,000 founders' shares it would otherwise have received upon consummation of the business combination. The target company has agreed to undertakings to enhance its disclosure controls, including creating an independent board committee and retaining an internal compliance consultant for two years.

SEC charges company and executives for misleading COVID-19 disclosures

The SEC settled charges against a health care company, its CEO and its chief technology officer for making misleading statements about their efforts to fight COVID-19.

According to the SEC's complaint, the company issued a series of press releases in March and April 2020 falsely claiming that it was developing a COVID-19 screening test that would be available soon and that it had medical and personal protective equipment for immediate sale. The complaint alleges that the company was insolvent at the time, and the timeline for making the test available would still have been false if the company had funding. In addition, the complaint alleges that its CEO drafted the misleading press releases that boosted the company's declining stock price.

Without admitting or denying the SEC's allegations, the company and both executives consented to judgments permanently enjoining them from future violations and requiring them to pay penalties totaling $185,000.

SEC charges company and former executives for engaging in accounting scheme

The SEC charged a food company, its former chief operating officer (COO) and former chief procurement officer (CPO) with engaging in a long-running expense management scheme that resulted in the restatement of several years of financial reporting.

According to the SEC's order, from the last quarter of 2015 to the end of 2018, the company engaged in various types of accounting misconduct, including recognizing unearned discounts from suppliers and maintaining false and misleading supplier contracts, which improperly reduced the company's cost of goods sold and allegedly achieved cost savings that were widely covered by financial analysts. The alleged accounting improprieties resulted in the company overstating a key earnings performance metric.

In June 2019, after the SEC began its investigation, the company restated its financial statements to correct $208 million in improperly recognized cost savings arising out of nearly 300 transactions. The order also found that the company failed to design and maintain effective internal accounting controls for its procurement division. As a result, finance and gatekeeping personnel repeatedly overlooked indications that expenses were being improperly accounted for.

Without admitting or denying the SEC's findings, the company, its former COO and former CPO consented to pay a civil penalty of $62 million, $300,000 and $100,000, respectively.

SEC announces three actions charging deficient cybersecurity procedures

The SEC has sanctioned eight firms in three actions for failures in their cybersecurity policies and procedures that resulted in email account takeovers exposing the personal information of thousands of customers and clients at each firm.

Five of the eight firms are part of the same financial services organization. According to the SEC's order against the five firms, cloud-based email accounts of over 60 personnel who work for the firms were taken over by unauthorized third parties between November 2017 and June 2020, resulting in the exposure of personally identifying information of at least 4,388 customers and clients. The order finds that none of the accounts in question were protected in a manner consistent with the firms' policies. The SEC's orders against the other three firms have similar findings.

Without admitting or denying the findings, all eight firms agreed to cease and desist from future violations of the charged provisions, to be censured and to pay penalties totaling $750,000.

What's next at the SEC?

We expect the SEC to continue to advance its regulatory agenda, with proposals on climate-related disclosures and cybersecurity governance disclosures possible in the coming months. At the same time, we expect the SEC staff to continue to issue comment letters to registrants about their compliance with the SEC's 2010 guidance on climate-related disclosures.

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