13 January 2022

SEC in Focus

Quarterly summary of current SEC activities

In this issue:

SEC staff focusing on materiality of error corrections

At the December 2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the Securities and Exchange Commission (SEC or Commission) staff highlighted the importance of maintaining objectivity when evaluating the materiality of errors identified in historical financial statements and how those errors should be corrected.

Registrants must evaluate the materiality of errors to determine whether to correct them by restating and reissuing the prior-period financial statements and filing a Form 8-K to communicate that the previously issued reports can no longer be relied on in what is known as a "Big R" restatement, by revising the comparative financial statements to correct and disclose the error in the current period in what is known as a "little r" restatement, or just correcting the error in the current-period financial statements because it is immaterial (i.e., an out-of-period correction).

The SEC staff emphasized that when applying SEC Staff Accounting Bulletin (SAB) Topic 1.M, Materiality, management should judiciously evaluate the total mix of information and consider all relevant quantitative and qualitative factors to determine whether an error is material to investors and other users of the financial statements. The SEC staff noted that the more quantitatively significant an error becomes, the more difficult it is to use qualitative factors to overcome a conclusion that the error is material and that a "Big R" restatement is warranted.

In a number of recent consultations, the SEC staff noted that it objected to registrants' conclusions that a quantitatively significant error, corrected as part of a "little r" restatement, was not material to the prior-period financial statements. In those cases, the staff considered the registrant's facts and circumstances and concluded that there was an insufficient basis to assert that the error was not material to the prior-period financial statements.

The SEC staff also reminded preparers and auditors that a registrant could have an error that is quantitatively small but conclude that the error is material based on an objective evaluation of qualitative factors that may not be solely limited to those listed in SAB Topic 1.M.

In addition to the evaluation of the error, the staff is also focused on the assessment of any control deficiencies resulting in the error (regardless of materiality) and whether they are indicative of a material weakness.

Separately, we have observed the staff increasing its scrutiny of registrants' evaluations of errors, how the errors are corrected and the related internal control assessments.

How we see it

Companies should strongly consider correcting any errors identified during the financial statement close process and the completion of the audit or review of the financial statements. Correcting these errors before the financial statements are issued will mitigate the risk that the error could accumulate over time to become material or could result in a material misstatement when aggregated with other immaterial errors identified in subsequent periods.

Progress on SEC regulatory agenda

The SEC continued to advance items on its regulatory agenda, focusing on enhanced disclosures and investor protection.

Clawbacks of incentive-based compensation after a restatement — The SEC has received feedback after it **reopened** the comment period on its 2015 proposal that would direct national securities exchanges to establish listing standards that would require companies to develop and implement policies to recover incentive-based compensation after an accounting restatement.

The proposal, which was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, would require companies to claw back incentive-based compensation received by current and former executive officers during the three years preceding an accounting restatement. The SEC sought comment on both the initial **proposal** and additional questions it raised in its reopening release, which include whether to subject "little r" restatements to the clawback provisions in addition to "Big R" restatements.

Money market fund reforms — The SEC **proposed** amending certain rules that govern money market funds (MMFs) under the Investment Company Act of 1940 that would, among other things:

- Increase minimum daily and weekly liquid asset requirements
- Remove the ability of MMFs to impose liquidity fees and redemption gates when liquid assets fall below certain thresholds
- Require institutional prime and institutional tax-exempt MMFs to implement swing pricing when such funds have net redemptions
- Enhance certain reporting requirements to improve the SEC's ability to monitor and analyze MMF data

The SEC also stated that the adoption of swing pricing would not preclude shareholders from classifying their investments in MMFs as cash equivalents under normal circumstances.

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

EY resources

- *To the Point, **SEC proposes requiring 'clawback' policies and disclosures***
- *To the Point, **SEC staff issues guidance on 'spring-loaded' share-based payment awards***

Amendments regarding Rule 10b5-1 insider trading plans and related disclosures — The SEC proposed adding conditions that would have to be met to assert the affirmative defense against insider trading liability in Exchange Act Rule 10b5-1, which allows trades based on a written plan known as a trading agreement that was adopted when the insider was not aware of material nonpublic information, among other things.

The proposal would impose cooling-off periods before trading could commence under a trading plan, prohibit multiple overlapping trading arrangements and limit the use of the affirmative defense for a trading arrangement designed to cover a single trade to one single-trade plan in any 12-month period. The proposal would also require directors and officers to furnish written certifications that they are not aware of any material nonpublic information when they enter into trading plans.

In addition, the proposal would require new disclosures about an issuer's policies and procedures related to insider trading, including tabular reporting of options granted within 14 days of the release of material nonpublic information and the market price of the underlying securities on the trading days before and after the release of such information.

Comments are due 45 days after publication in the Federal Register.

How we see it

Entities should consider this proposal in conjunction with SAB 120, which provides guidance on the measurement and disclosure of share-based payment arrangements entered into when a company is in possession of material nonpublic information to which the market is likely to react when announced (see further discussion below).

We also encourage companies to evaluate their governance policies and related internal control over financial reporting for awards granted within 14 days of the release of material nonpublic financial information given the proposed disclosure requirements and accounting guidance in SAB 120.

Share repurchase disclosure modernization — The SEC proposed requiring issuers to provide disclosures about repurchases of their equity securities before the end of the first business day following the execution of a share repurchase. Issuers would be required to disclose on proposed Form SR the total number and class of securities purchased, the average price paid per share and the total number of shares purchased pursuant to a plan intended to satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c).

The proposal would also require an issuer to disclose:

- The objective or rationale for its share repurchases and the process or criteria used to determine the amount of repurchases
- Any policies and procedures relating to purchases and sales of the issuer's securities by its officers and directors during a repurchase program, including any restrictions
- Whether repurchases were made pursuant to a plan intended to satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c)
- Whether repurchases were made in reliance on the nonexclusive safe harbor of Exchange Act Rule 10b-18

Comments are due 45 days after publication in the Federal Register.

Other SEC rulemaking and staff initiatives

LIBOR transition

The SEC staff issued a **statement** reminding investment professionals of their obligations when recommending securities linked to the London Interbank Offered Rate (LIBOR) and reminding companies and issuers of asset-backed securities of their disclosure obligations related to the transition away from LIBOR.

In the statement, the staff encouraged companies to provide detailed qualitative disclosures and, when material, quantitative disclosures, such as the notional value of contracts referencing LIBOR that extend past 31 December 2021 or 30 June 2023 (the cessation dates for USD LIBOR settings), to provide context for their disclosures about their transition efforts and related risks. The staff also said that companies that have taken or are taking steps to identify their exposure and mitigate material risks or potential impacts should consider disclosing what they have done, what steps remain and the timeline for further efforts.

In addition, the staff recommended that companies that address LIBOR in response to more than one disclosure requirement (e.g., in risk factors, management's discussion and analysis, recent developments, and qualitative and quantitative disclosures about market risk) consider cross-referencing or summarizing the disclosures.

Spring-loaded share-based payments

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- *SEC Reporting Update: 2022 proxy statements — An overview of the requirements and observations about current practice*

The SEC staff issued **SAB 120** to provide interpretive guidance on the measurement and disclosure of share-based payments commonly referred to as being "spring-loaded" because they are granted when a company is in possession of material non-public information to which the market is likely to react positively when it is announced.

The SEC staff said in the SAB that a registrant that enters into a share-based payment arrangement in contemplation of or shortly before a planned release of material nonpublic information should determine whether adjustments to the observable market price or expected volatility may be appropriate to meet the fair value measurement objectives of Accounting Standards Codification (ASC) 718, *Compensation*, for estimating compensation cost.

Determining whether an adjustment is necessary, and if so, the magnitude of any adjustment, requires significant judgment, the SEC staff said. Further, at a minimum, the staff said it expects companies to disclose how they determined the current share price, including how they determined when an adjustment is required and any significant assumptions used to calculate such an adjustment.

Shareholder proposals

The SEC's Division of Corporation Finance (DCF) issued **Staff Legal Bulletin (SLB) 14L**, *Shareholder Proposals*, which said that the SEC staff will no longer focus on the significance of a policy issue that is the subject of a shareholder proposal to a company, but it will instead consider whether the proposal raises issues with a broad societal impact, such that those issues transcend the ordinary business of the company. Under this approach, the SEC staff no longer expects a company's no-action request to include a discussion that reflects the board of directors' analysis of the policy issue raised and its significance. The SEC staff said that SLB 14L is intended to streamline and simplify the process for companies to submit no-action requests to them. In issuing SLB 14L, the staff rescinded SLBs 14I, 14J and 14K.

The staff of the DCF also announced it will return to the prior practice of responding to each shareholder proposal no-action request with a written letter.

Universal proxy cards and proxy voting

The SEC adopted **amendments** to its rules that require the use of universal proxy cards in all non-exempt solicitations involving contested elections of directors. The rules require that universal proxy cards include the names of candidates nominated by both a registrant and dissident shareholders to allow shareholders to vote by proxy in a manner that more closely resembles how they can vote in person at a shareholder meeting, among other things. Companies will need to comply with the amended rules for a shareholder meeting involving a contested director election after 31 August 2022.

The SEC also **proposed** rescinding two conditions it added in 2020 to its proxy solicitation rules on exemptions that proxy voting advice businesses typically rely on to avoid the information and filing requirements (i.e., Securities Exchange Act of 1934 Rules 14a-2(b)(1) and (b)(3)).

The conditions that would be rescinded require proxy advisory firms to:

- Disclose specified conflicts of interest to shareholders in or along with their proxy voting advice
- Develop and publicly disclose policies and procedures such that:
  - Any company that is the subject of voting advice by the proxy advisory firm has that advice made available to them before or at the same time that it is made available to shareholders
  - Shareholders can reasonably expect to be provided with a company's written response to the proxy advisory firm's voting advice in a timely manner before the shareholders' meeting

Comments were due December 27, 2021.

> "[W]e remain committed to working with the PCAOB and our domestic and international counterparts to continue to implement the HFCAA.
>
> — SEC Chairman Gary Gensler

Holding Foreign Companies Accountable Act

The SEC amended its interim final rules to implement the Holding Foreign Companies Accountable Act (HFCAA). The rules require registrants that the SEC identifies as having filed an annual report in which the principal auditor's report has been issued by a firm located in a foreign jurisdiction that the Public Company Accounting Oversight Board (PCAOB) is unable to inspect or investigate (Commission-Identified Issuers) to comply with the submission and disclosure requirements in the annual report for each year in which they are identified. In addition, an issuer that is identified for three consecutive years would be subject to a trading prohibition.

The SEC will identify Commission-Identified Issuers for fiscal years beginning after 18 December 2020. All registrants will be required to use an updated XBRL taxonomy that includes tags that will help the Commission identify the covered issuers beginning with annual reports for years ending after 15 December 2021.

Separately, the SEC approved **PCAOB Rule 6100**, *Board Determinations Under the Holding Foreign Companies Accountable Act*, which provides a framework for the PCAOB 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 PCAOB issued its first **report** under this rule, notifying the SEC of its determinations that it is unable to inspect or completely investigate PCAOB-registered public accounting firms headquartered in both mainland China and in Hong Kong because of a position taken by authorities there.

Separately, the DCF issued a **sample letter** containing comments that the division may issue to China-based companies depending on the facts and circumstances.

AICPA & CIMA Conference on Current SEC and PCAOB Developments

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- *2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments*

As discussed above, the annual AICPA & CIMA Conference on Current SEC and PCAOB Developments was held in December 2021.

The speakers and panelists included representatives of the SEC, the Financial Accounting Standards Board, the International Accounting Standards Board and the PCAOB who shared their views on various accounting, financial reporting, auditing and regulatory issues.

The theme of the conference was how regulators, standard setters, preparers and auditors can provide investors with high-quality, decision-useful financial information. "Each stakeholder should constantly reassess its areas of focus in light of changing priorities, evolving investor needs and updates to standards, rules and regulations," said SEC Acting Chief Accountant Paul Munter.

Among the topics addressed were materiality of error corrections and LIBOR transition, as discussed above, and the following:

Environmental, social and governance matters — SEC officials reminded companies of the Commission's **2010 climate change guidance**, indicating that the SEC staff will continue to review issuers' climate-related disclosures while rulemaking is underway. The SEC staff expects companies to consider the 2010 guidance and its recently published **sample comment letter** on climate-change-related disclosures in their year-end reporting.

Revenue recognition — The SEC staff said that revenue recognition continues to be a frequent topic of consultations, especially in areas such as principal vs. agent considerations, identification of performance obligations and consideration payable to a customer. The staff discussed some challenges in applying the guidance in fact patterns involving technology companies, including platform business models.

Audit matters — SEC officials stressed the importance of auditor independence and compliance with the Commission's independence rules, particularly the general standard of auditor independence. PCAOB staff members provided an update on the PCAOB's standard-setting projects and discussed the inspection outlook for 2022. The timing and prioritization of PCAOB projects are expected to be reassessed once all the newly appointed PCAOB members (see below) are sworn in.

Personnel changes

New PCAOB chair and board members sworn in

Erica Y. Williams was sworn in as Chairperson of the PCAOB. Christina Ho, Kara M. Stein and Anthony C. Thompson were sworn in as PCAOB members. The SEC had **appointed** them in November. Duane DesParte will continue to serve as a PCAOB member.

Ms. Williams is a litigation partner at Kirkland & Ellis LLP and previously spent more than a decade in various roles at the SEC, including as deputy chief of staff to three former SEC chairpersons and assistant chief litigation counsel in the SEC's Division of Enforcement trial unit.

Ms. Ho had been vice president of Government Analytics and Innovation at Elder Research and previously served as the deputy assistant secretary for Financial Transparency & Accounting Policy at the US Department of the Treasury.

Ms. Stein was an SEC commissioner from 2013 to 2019, and prior to her appointment, she was a policy fellow and lecturer at the University of Pennsylvania Carey Law School and director of the Artificial Intelligence, Data, and Capital Markets Initiative at the Center on Innovation, University of California Hastings Law.

Mr. Thompson was executive director and chief administrative officer of the Commodity Futures Trading Commission, where he oversaw the Division of Administration. He previously held senior positions at the US Department of Agriculture.

SEC Commissioner Roisman to step down

SEC Commissioner Elad L. Roisman announced his intention to resign by the end of January. Mr. Roisman has served on the Commission since September 2018 and was acting chairman from December 2020 to January 2021. His departure will leave Commissioner Hester M. Peirce as the only Republican on the Commission until a new commissioner is nominated by President Joe Biden and confirmed by the Senate.

> "This year has seen a number of critically important and first-of-their-kind enforcement actions, as well as record-breaking achievements for our whistleblower program, which we expect will lead to even more successful actions in the future.
>
> —SEC Division of Enforcement Director Gurbir S. Grewal

Enforcement activities

SEC announces enforcement results for 2021

The SEC announced that its Division of Enforcement brought 697 enforcement actions, including 434 new actions, and obtained judgments and orders for nearly $2.4 billion in disgorgement and more than $1.4 billion in penalties during its fiscal year ended 30 September 2021. In addition, the SEC awarded a record $564 million to 108 whistleblowers in fiscal year 2021, both the highest dollar amount and the highest number of individuals to receive awards in any fiscal year.

The division's new actions involved a wide range of issues, including those related to digital assets and special purpose acquisition companies.

Medical services provider, executives charged with revenue manipulation scheme

The SEC charged a medical services provider with allegedly engaging in a revenue manipulation scheme resulting in the restatement of several years of financial reporting. The SEC also charged two of the company's former chief financial officers and its former controller for their alleged misconduct related to the scheme.

According to the SEC's complaint, the company improperly manipulated certain revenue adjustments to embellish the company's financial performance. The complaint alleges that the company improperly recognized topside adjustments to hit targets on two key financial metrics. The complaint further alleges that this scheme included the use of a revenue "cookie jar," whereby the company identified topside adjustments that should properly be recorded but did not actually record them until the revenue adjustments were needed to meet key financial targets. Finally, the defendants allegedly misled the company's auditor to prevent the discovery of the improper accounting practices.

Without admitting or denying the allegations in the complaint, the company agreed to settle by consenting to a permanent injunction and a $2 million civil penalty, subject to court approval.

Oilfield services company, ex-CEO charged with failure to make certain disclosures

The SEC charged an oilfield services company and its founder and former chief executive officer (CEO) with allegedly failing to disclose executive perks and stock pledges. According to the SEC's order, the former CEO caused the company to incur personal and travel expenses unrelated to the performance of his duties as CEO. The former CEO also allegedly failed to

disclose that all of his company stock had been pledged as collateral to secure loans to purchase real estate. The company also allegedly failed to properly disclose additional, authorized perks it paid to the former CEO and failed to accurately record the former CEO's perks in its books and records.

Without admitting or denying the allegations, the company and the former CEO agreed to cease and desist from further violations, and the former CEO agreed to pay a $0.2 million penalty.

What's next at the SEC?

The SEC is expected to issue in early 2022 a proposal that is anticipated to require a variety of qualitative and quantitative climate risk disclosures in SEC filings. As calendar year-end registrants file their 2021 annual reports, they should keep in mind that the SEC staff is expected to continue to focus on the quality of issuers' disclosures, including those related to climate change.

The SEC also is expected to issue in early 2022 a proposal on cybersecurity risk governance and human capital disclosures, including those related to workforce and board diversity.