

# SEC in Focus

Quarterly summary of current SEC activities

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## Regulators focus on fraud risk, financial reporting, audit quality

The annual AICPA & CIMA Conference on Current SEC and PCAOB Developments in December 2022 in Washington, DC covered a broad range of financial reporting topics and emerging issues.

The speakers and panelists included representatives of the Securities and Exchange Commission (SEC or Commission), the Financial Accounting Standards Board (FASB), the Public Company Accounting Oversight Board (PCAOB) and the International Accounting Standards Board (IASB), who shared their views on various accounting, financial reporting, auditing and regulatory issues.

They discussed the importance of high-quality, transparent financial information in the current macroeconomic environment and the role regulators, standard setters, preparers and auditors play in protecting investors.

Regulators, standard setters and other speakers also reflected on improvements in financial reporting and audit quality in the 20 years since the Sarbanes-Oxley Act was enacted. However, they said the recent trend of increases in findings in PCAOB inspections of audit work needs to be reversed, and gatekeepers, including auditors, need to remain focused on maintaining high standards, especially given the current economic uncertainty that may increase the risk of fraud. They also reminded auditors of their responsibilities to be independent, ethical and skeptical.

Highlights included:

**Fraud risk** – SEC and PCAOB officials stressed that the current macroeconomic environment may increase the risk of fraud and said auditors should embed this risk in their planning processes as well as exercise professional skepticism. They also discussed how auditors, preparers and audit committees should respond to heightened fraud risks and the risk of management bias.

**Non-GAAP financial measures** – The SEC staff discussed its continuing focus on non-GAAP financial measures and announced updates to its compliance and disclosure interpretations (C&DIs) on non-GAAP financial measures, which are discussed below.

**Crypto assets** – SEC and FASB representatives discussed the accounting, disclosure and auditing challenges posed by crypto asset arrangements, due to the unique risks and uncertainties associated with them and the fact that the arrangements continue to evolve. The FASB staff discussed its project on the accounting for crypto assets, and the SEC staff indicated that it will continue to prioritize enforcement actions in cryptocurrency markets.

**PCAOB activities** – PCAOB members noted that audit deficiencies are increasing and that auditors need to demonstrate due professional care and professional skepticism, especially in the current macroeconomic environment (i.e., applying the same audit approach as last year may not be appropriate). They emphasized that auditor independence is foundational to audit quality and that management and the audit committee also play a role in auditor independence. PCAOB officials reiterated their plans to strengthen their enforcement and inspection activities.

**Accounting updates** – SEC and FASB representatives discussed ways to provide investors with more transparent financial information, including more disaggregated financial information and more information on environmental, social and governance (ESG) matters. FASB representatives also discussed the FASB's post-implementation reviews of the revenue, leases and credit losses guidance and stressed the importance of stakeholder feedback throughout the standard-setting process.

**Disclosures on ESG and cybersecurity matters** – While the SEC is finalizing new rules on climate-related and cybersecurity disclosures, the SEC staff reminded registrants of the Commission's 2010 climate change interpretive guidance and its 2018 statement and interpretive guidance on cybersecurity disclosures. The SEC staff also indicated that it will continue to review registrants' climate-related disclosures and expects registrants to consider the 2010 guidance and the staff's sample comment letter on climate-change-related disclosures in their year-end reporting.

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#### EY resources

- ▶ [2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments](#)
- ▶ [To the Point, SEC adopts rules to require 'clawback' policies and disclosures](#)
- ▶ [Technical Line, Applying the SEC's new requirements for significant acquired businesses](#)

## SEC staff updates guidance on non-GAAP financial measures

The SEC staff **revised** its C&DIs on non-GAAP financial measures. The SEC staff said the revisions are intended to reflect views it has previously communicated rather than provide any new guidance.

C&DI Question 100.01 was updated to address how the staff considers whether operating expenses are "normal" or "recurring" and, therefore, whether their exclusion from a non-GAAP financial measure could be misleading. The updated C&DI notes that the staff considers how the nature and effect of non-GAAP adjustments relate to the company's operations, revenue-generating activities, business strategy and regulatory environment as well as the staff's view that an operating expense that occurs repeatedly or occasionally, including at irregular intervals, is recurring.

C&DI Question 100.04 was updated to provide examples of non-GAAP adjustments to both revenue and expenses that could have the effect of changing the recognition and measurement principles required by GAAP, thereby rendering them "individually tailored" and potentially resulting in a misleading measure.

C&DI Questions 102.10(a) through (c) provide additional examples of (1) when non-GAAP measures are considered more prominent than the comparable GAAP measures and disclosures and (2) presentations that would cause the non-GAAP reconciliation required by

Item 10(e)(1)(i)(B) of Regulation S-K to give undue prominence to a non-GAAP measure. They also clarify that the staff believes a non-GAAP income statement is one that comprises non-GAAP measures and includes all or most of the line items and subtotals found in a GAAP income statement.

The newly added C&DI Questions 100.05 and 100.06 clarify that a non-GAAP financial measure (or an adjustment made to a GAAP measure) can be misleading if it is not appropriately labeled and clearly described and the SEC staff's view that disclosure cannot be used to cure a misleading measure.

## SEC adopts rules to require 'clawback' policies and disclosures

The SEC **adopted** final rules directing national securities exchanges to establish listing standards that require companies to claw back incentive-based compensation from current and former executives if the company is required to prepare an accounting restatement. The rules also require companies to disclose their clawback policies and any compensation subject to clawback in annual reports and in proxy and information statements.

The rules, which were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, define executive officer broadly and require clawbacks regardless of whether an executive officer was at fault. A company that doesn't implement a policy that complies with the rules, disclose it or comply with its provisions could be subject to delisting.

The rules apply to most listed companies, including smaller reporting companies, emerging growth companies (EGCs) and foreign private issuers. They don't apply to certain registered investment companies and unit investment trusts.

Exchanges have until 28 November 2023 to put the new listing standards into effect. Companies have an additional 60 days from that effective date to adopt a compliant policy and to provide the required disclosures, meaning compliance will likely be required in 2024.

### How we see it

While many companies voluntarily adopted clawback policies since the proposal was issued in 2015, they will likely need to revise them in light of the new rules. Many voluntary policies only apply to cases of fraud or misconduct, and some apply to a narrower group of executives or have a shorter lookback period than required by the SEC rules.

## Amended rules on Rule 10b5-1 insider trading plans, disclosures

The SEC **adopted** amendments 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 agreement known as a trading plan that was adopted when the insider was not aware of material nonpublic information, among other things.

The amendments impose cooling-off periods before trading can commence under a trading plan and add a condition that all persons entering into a trading plan under Rule 10b5-1 must certify they are acting in good faith and not aware of any material nonpublic information at that time. The amendments prohibit persons (other than issuers) from having multiple overlapping trading plans 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 amendments also require new tabular and narrative disclosures in both periodic filings and proxy and information statements and include new Form 4 and Form 5 filing requirements.

The final rules will become effective on 27 February 2023, and individuals will be required to comply with the amendments in beneficial ownership reports filed on or after 1 April 2023. Registrants will be required to comply with the disclosure requirements in the first periodic report on Forms 10-Q, 10-K and 20-F and proxy or information statements that cover the first full fiscal period beginning on or after 1 April 2023.

## Sample comment letter on crypto market developments

The SEC's Division of Corporation Finance posted a sample [comment letter](#) on the SEC's website to illustrate the types of comments it may issue to companies impacted directly or indirectly by bankruptcies and the financial distress among crypto market participants.

Impacted companies should consider these comments when drafting disclosures for upcoming periodic reports and address their exposure to counterparties and other market participants, risks related to their liquidity and ability to obtain financing, and risks related to legal proceedings, investigations or regulatory impacts in the crypto asset markets.

## Final rule on fund shareholder reports, disclosures

The SEC [adopted](#) rule and form amendments that will require mutual funds and exchange-traded funds to transmit concise and visually engaging shareholder reports and will also promote transparent and balanced presentations of fees and expenses in investment company advertisements for registered investment companies and business development companies.

The rule requires a fund to send its annual and semiannual shareholder reports that highlight important information, such as fund expenses, performance and portfolio holdings, within 60 days of period end to its investors by mail, unless they elect electronic delivery. Funds are no longer required to include their financial statements in shareholder reports; however, they are required to post their audited annual financial statements on their website within 60 days of period end. Funds still have 70 days to file Form N-CSR with the SEC.

The compliance date of the final rule amendments addressing representations of fees and expenses in investment company advertisements is 24 January 2023. The compliance date for the remaining rule amendments is 24 July 2024.

## Final rule on fund, institutional investment manager proxy voting records

The SEC [adopted](#) rule and form amendments to enhance the information registered funds currently report on Form N-PX about their proxy votes by requiring funds to categorize voting matters by type and disclose that their proxy voting records are publicly available on or through their websites and available upon request, among other things. The rule also requires institutional investment managers to annually report on Form N-PX how they voted on certain executive compensation matters (i.e., "say-on-pay" votes).

The new rule and form amendments will be effective for votes occurring on or after 1 July 2023, with the first filings subject to the amendments due in 2024.

## Proposed rule for certain services outsourced by investment advisers

The SEC [proposed](#) prohibiting registered investment advisers from outsourcing certain services or functions without conducting due diligence before engaging the provider. The proposal would require the advisers to periodically monitor the provider's performance and reassess whether to retain the provider, among other things.

## Proposed updates to open-end fund liquidity framework

The SEC **proposed** rule and form amendments to prepare open-end funds for stressed conditions and mitigate dilution of shareholders' interests. The proposal would:

- ▶ Require most open-end funds to maintain a minimum of 10% of net assets in highly liquid assets, provide standards for liquidity classifications, require funds to incorporate stress into these classifications and amend liquidity categories (e.g., remove the less liquid investment category)
- ▶ Require open-end funds, other than money market funds or exchange-traded funds, to adjust their net asset value (NAV) per share by a swing factor when experiencing net redemptions or net purchases exceeding a threshold and implement a hard close for investors' orders before NAV is calculated
- ▶ Require more frequent reporting of portfolio holdings and more detailed public reporting of fund information, including information about funds' liquidity risk management and use of swing pricing

Comments are due by 14 February 2023.

## Other SEC matters

### Highlights from CAQ – SEC Regulations Committee meetings

The Center for Audit Quality SEC Regulations Committee released its **minutes** for meetings held in September 2021 and March 2022. Guidance provided by the SEC staff addressed various matters related to performing significance tests in accordance with Rule 1-02(w) of Regulation S-X for the purpose of complying with Rules 3-05 and 3-09 of Regulation S-X.

Specifically, the staff addressed the application of the significance tests when a subsidiary of a registrant that is not wholly owned acquires a business (e.g., a registrant consolidates a 60%-owned operating company, which acquires 100% of an unrelated target), noting the following:

- ▶ When performing the asset test and calculating the revenue component of the income test, 100% of the target's assets and revenue from continuing operations should be used in the numerator, and 100% of the registrant's assets and revenue should be used in the denominator. That is, the registrant's 60% ownership of the operating company does not affect these calculations.
- ▶ For the income component of the income test, the numerator should reflect only 60% of the target's pretax income/loss (i.e., income/loss attributable to controlling interest). The denominator should be the registrant's income/loss attributable from continuing operations before the income tax attributable to the controlling interest, which also excludes pretax income/loss attributable to noncontrolling interests.

In addition, various financial statement requirements for mergers between a private company and a special purpose acquisition company (SPAC), known as de-SPAC transactions, including those for when a de-SPAC target loses its EGC status, as well as pre-merger SPAC financial statement requirements in a registration statement were discussed.

### SEC publishes five-year strategic plan

The SEC published its five-year **strategic plan** outlining its objectives to protect the investing public against fraud and misconduct; maintain a regulatory framework that keeps pace with evolving markets, business models and technologies; and sustain a skilled and diverse workforce.

## SEC approves PCAOB budget and accounting support fees

The SEC approved the PCAOB's fiscal year 2023 budget of \$349.5 million, up 12.6% from the prior fiscal year. It also approved annual accounting support fees of \$329.4 million, up 10.6% from the prior fiscal year. Public company issuers will be assessed \$300.3 million of the accounting support fees, and registered broker-dealers will be assessed \$29.1 million, the SEC said.

## Paul Munter named SEC's Chief Accountant

The SEC appointed Paul Munter Chief Accountant. Mr. Munter will continue to lead the SEC's Office of the Chief Accountant and serve as the principal adviser to the Commission on accounting and auditing matters. He had served as Acting Chief Accountant since January 2021.

## Enforcement activities

### SEC brought 760 enforcement actions in 2022

The SEC announced its Division of Enforcement results for the fiscal year ended 30 September 2022. The report stated that the division:

- ▶ Brought 760 enforcement actions, a 9% increase from the prior year, including 462 standalone actions
- ▶ Obtained civil penalties of nearly \$4.2 billion, the highest on record, compared with more than \$1.4 billion in the prior year
- ▶ Ordered more than \$2.2 billion in disgorgement, a 6% decrease from the prior year

The enforcement actions focused on crypto assets, cybersecurity, ESG and private funds, among others. In addition, the SEC awarded approximately \$229 million to 103 whistleblowers in fiscal year 2022, the second highest on record in terms of both dollar amounts and number of awards, compared with the record \$564 million in awards to 108 whistleblowers in the prior year.

### SEC charges company with disclosing material misleading non-GAAP information

The SEC charged a global manufacturing company with failing to disclose material information about non-GAAP financial measures that the company highlighted in its press releases and earnings calls to demonstrate its progress in meeting its debt reduction goals.

The SEC's order alleged that the company's public statements were misleading because the company failed to disclose that it met its debt reduction goals by delaying significant payments on past due vendor invoices, which resulted in only temporary reductions that reversed when the company drew on a line of credit to pay the vendors soon after the close of the reporting periods.

The SEC's order alleged that the company violated the anti-fraud provision of the federal securities laws and certain rules and provisions under the Exchange Act, including Regulation G.

Without admitting or denying the SEC's findings, the company consented to a cease-and-desist order and a civil penalty of \$1.3 million.

### SEC charges company, former senior executive with accounting fraud

The SEC charged a cannabis company with improperly recognizing revenue and making other material accounting errors in financial statements for multiple reporting periods. The company reported the misconduct to the SEC and took effective remedial steps.

The SEC's order alleged that the company violated the anti-fraud, reporting, books and records, and internal control provisions of the federal securities laws. Without admitting or denying the SEC's findings, the company offered to settle the matter by agreeing to cease and

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As reflected in these results, the Enforcement Division is working with a sense of urgency to protect investors, hold wrongdoers accountable and deter future misconduct in our financial markets.

— Director of the SEC's  
Division of Enforcement,  
Gurbir S. Grewal

desist from future violations and retain an independent compliance consultant to make recommendations about its financial reporting and accounting controls. In agreeing to settle with the company, the SEC didn't impose a financial penalty given the company's timely self-reporting, significant cooperation and remediation.

The SEC also charged a former executive of the company with fraud and aiding and abetting the company's violations. Without admitting or denying the findings, the former executive settled the matter by agreeing to cease and desist from future violations, a three-year officer and director bar, and a three-year suspension from practicing as an accountant before the SEC. The SEC did not impose a penalty on the former executive in light of his agreement to pay a penalty to another regulator for similar conduct.

## What's next at the SEC?

In the coming year, we expect the SEC to continue to advance its priorities, including its ambitious rulemaking agenda and its oversight and enforcement programs to protect investors, including those who invest in crypto assets. We expect the SEC to finalize a number of proposals, including those on climate-related disclosures and cybersecurity disclosures, and propose additional rules on human capital and board diversity disclosures, among other things.

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