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# SEC in Focus

Quarterly summary of current SEC activities

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## Update on SEC priorities in 2023

The Securities and Exchange Commission (SEC or Commission) is expected to continue its active rulemaking pace in 2023, focusing on disclosure rulemaking (e.g., climate, cybersecurity risk, human capital), the proxy process, regulation of crypto assets and enforcement matters. Despite delays in some rulemaking activity, the SEC's regulatory agenda suggests that Chair Gary Gensler remains committed to delivering on his key priorities in the year ahead.

SEC activity in the first quarter, discussed further below, included various proposals impacting asset managers and new staff guidance addressing the recent clawback and pay versus performance (PvP) rules, among other topics.

For further discussion of the SEC's 2023 priorities refer to our **publication**, *SEC top four*, *What public companies, boards and investors should watch for in 2023*.

## SEC comment letters focus on non-GAAP measures

The SEC staff further increased its focus on non-GAAP financial measures issuing comment letters to registrants that it believes may not be in compliance with Item 10(e) of Regulation S-K, Regulation G, and the SEC staff's compliance and disclosure interpretations (C&DIs) on this topic, which were recently updated.

Comments on non-GAAP measures topped our list of the most frequent topics in SEC staff comment letters for the year ended 30 June 2022, and the volume of such comments continues to grow. We recently observed an increase in comments related to measures that the SEC staff believes are misleading due to an individually tailored recognition or accounting principle or the exclusion of normal, recurring cash operating expenses.

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- *SEC Reporting Update: Highlights of trends in 2022 SEC comment letters*
- *2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments*

For example, the SEC staff has asked registrants to revise their presentation to omit an adjustment for tax valuation allowances in the calculation of adjusted net income and adjusted diluted earnings per share because the staff views it to result from the application of an individually tailored recognition principle.

We have also observed comments from the SEC staff requesting registrants to remove certain adjustments from their non-GAAP measures for costs that are considered "normal" and "recurring" operating expenses for their industry. For example, the SEC staff said it would typically view the opening and closing of a retailer's stores (or restaurants in the hospitality industry) as a normal operating activity for the business that should not be excluded from its non-GAAP measure. The SEC staff also noted that although a retailer may not open or close stores frequently, the costs associated with openings and closings would also be considered recurring expenses.

### How we see it

Companies that receive questions from the SEC staff about non-GAAP measures should be prepared to revise subsequent filings, earnings releases, earnings guidance and other documents containing such measures following a staff objection, including revising any comparative data.

Further, companies that are considering making changes to their non-GAAP measures or presenting new non-GAAP measures should assess whether such changes would comply with SEC rules and related SEC staff guidance. If it is unclear whether they do, the company should consider how its overall corporate reporting would have to change if the SEC staff were to object to the updated measure or adjustment.

## SEC rulemaking and staff guidance updates

### SEC proposes expanding custody rule to include all client assets, such as crypto assets

The SEC **proposed** rule amendments that would expand the scope of Rule 206(4)-2 under the Investment Advisers Act of 1940 (known as the custody rule) beyond client funds and securities to include any client assets, such as crypto assets, that are in a registered investment adviser's possession or that the adviser has discretionary authority to trade.

The proposed amendments also would refine the definition of qualified custodian, increase requirements for a foreign financial institution to be eligible to serve as a qualified custodian and provide additional rules on how qualified custodians must hold client assets. Qualified custodians would also be required to obtain a written internal control report that includes an opinion from an independent public accountant at least annually.

Advisers would be required to enter into a written agreement with and obtain certain assurances from qualified custodians to make sure clients receive certain standard custodial protections (e.g., segregation of assets, standard of care, indemnification) when an adviser has custody of their assets. Among other things, they also would be required to enter into a written agreement with an independent public accountant for the completion of verification procedures over privately offered securities and physical assets that cannot be maintained by a qualified custodian.

Comments are due by 8 May 2023.

*EY resources*

- *To the Point, **SEC adopts rules to require 'clawback' policies and disclosures***
- *Technical Line, **How to apply the SEC's new pay versus performance disclosure requirements***

## SEC staff publishes guidance on clawbacks of incentive-based compensation

The SEC staff **published** C&DIs on the incentive-based compensation clawback rule to:

- Clarify that until registrants are required to have a compensation recovery policy under an exchange listing standard, they are not expected to comply with the rule's disclosure requirements, including the use of the new check boxes added to the cover pages of Forms 10-K, 20-F and 40-F
- Emphasize that the rule is intended to apply broadly to incentive-based compensation, and therefore, registrants are expected to claw back amounts contributed to any sort of plan (other than a tax-qualified retirement plan) and any related accrued earnings based on erroneously awarded incentive-based compensation
- Explain which persons are considered named executive officers for purposes of clawback disclosures in Forms 20-F and 40-F

As a reminder, the rule directs national securities exchanges and associations to establish listing standards that require listed companies to claw back incentive-based compensation received by current and former executives during the three years preceding an accounting restatement. Both the NYSE and NASDAQ have submitted proposed updates to their listing standards to the SEC for approval. The listing standards have to be effective no later than 28 November 2023. Registrants have to adopt clawback polices within 60 days of the applicable listing standard's effective date.

## SEC staff publishes guidance on the pay versus performance rules

The SEC staff **published** C&DIs on the recently effective PvP rules to clarify the following, among other things:

- When calculating executive "compensation actually paid" in the first year an employee becomes a named executive officer (NEO), a registrant must include the change in fair value of all equity awards issued to the employee, including awards granted before the employee became an NEO.
- A registrant must provide footnote disclosure to describe the adjustments it makes to calculate executive "compensation actually paid" for its most recent fiscal year and in any year in which the adjustments are material to investors. However, the registrant must describe the adjustments for all periods presented the first time it provides the table.
- A registrant may use a peer group that is disclosed in its compensation discussion and analysis as its peer group for the purpose of the PvP disclosures, even if the group is not used for compensation "benchmarking" under Item 402 of Regulation S-K.
- A registrant could use its stock price as a company-selected financial performance measure only if it is a market condition in an incentive plan award or if it is used to determine the size of a bonus pool.
- A registrant with multiple principal executive officers (PEOs) in a fiscal year may aggregate the PEOs' compensation for purposes of the narrative, graphical or combined comparison between "compensation actually paid" and total shareholder return (TSR), net income and the company-selected measure if that presentation will not be misleading to investors.
- A registrant that changes its fiscal year during the time period covered by the PvP table should provide the PvP disclosures for the "stub period" and should not annualize or restate compensation.

As a reminder, the PvP rules require disclosure of the relationship between executive compensation and financial performance (i.e., TSR, net income and a company-selected measure) for the five most recently completed fiscal years in proxy and information statements that are required to include executive compensation disclosures. The rules apply to all registrants except emerging growth companies, foreign private issuers and registered investment companies other than business development companies. Smaller reporting companies may provide scaled disclosures. Calendar-year registrants must begin providing the disclosures in proxy and information statements filed this year.

### SEC staff updates Financial Reporting Manual

The staff of the SEC's Division of Corporation Finance (DCF or Division) updated its **Financial Reporting Manual** to, among other things:

- Incorporate recent amendments to Rules 3-10 and 3-16 and new Rules 13-01 and 13-02 of Regulation S-X, including related interpretive guidance
- Add guidance to clarify the transition for Accounting Standards Update 2018-12, *Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*, upon filing a registration statement in the year of adoption
- Update the emerging growth company revenue threshold to reflect the latest inflation adjustment
- Remove outdated information (e.g., guidance on the adoption of Accounting Standards Codification 606) and update contact information to facilitate communications with the DCF's Office of the Chief Accountant

### SEC staff updates guidance related to the tender offer rules and schedules

The SEC staff **updated** its C&DIs related to the tender offer rules and schedules to replace the interpretations published in the Manual of Publicly Available Telephone Interpretations and on the SEC's website. With this update, all tender offer-related guidance has been consolidated into the C&DIs.

## Other SEC matters

### 2023 US GAAP financial reporting and SEC reporting taxonomies available for use

The 2023 US GAAP financial reporting taxonomy (2023 GRT) and the 2023 SEC reporting taxonomy (2023 SRT) for XBRL reporting have been accepted by the SEC and released for public use. The 2023 GRT contains updates for amendments from accounting standards and other improvements since last year. The 2023 SRT updates primarily relate to improvements for SEC Staff Accounting Bulletin No. 121 on obligations to safeguard crypto assets that an entity holds for platform users.

The SEC staff strongly encourages companies to use the most recent version of the respective taxonomy for their submissions to take advantage of the most up-to-date tags.

### Gerding named Director of SEC's Division of Corporation Finance

The SEC **appointed** Erik Gerding as Director of the SEC's DCF to succeed Renee Jones, who has returned to her faculty position at Boston College Law School. Mr. Gerding previously served as the DCF's Deputy Director and led legal and regulatory policy at the Division.

## Enforcement activities

### SEC charges IT services provider for misleading non-GAAP disclosures

The SEC charged an information technology (IT) services company with making misleading disclosures about its non-GAAP financial performance in multiple periodic filings and earnings releases. The SEC's order alleged that the company negligently misclassified a material amount of expenses as transaction, separation and integration-related costs and improperly excluded those costs from its non-GAAP measures. The order also alleged that the company did not have a non-GAAP policy or adequate disclosure controls and procedures in place related to its non-GAAP financial measures.

Without admitting or denying the SEC's findings, the company consented to a cease-and-desist order, agreed to pay an $8 million civil penalty and also agreed to develop and implement appropriate non-GAAP policies and disclosure controls and procedures.

### SEC charges company for misleading disclosures about ransomware attack

The SEC charged a software provider for making misleading disclosures about a ransomware attack that impacted more than 13,000 customers. The SEC's order alleged that the company filed a Form 10-Q that disclosed the incident but failed to include material information about the scope of the attack and misleadingly characterized the risk of exfiltration of sensitive information as hypothetical. The order also alleged the company failed to maintain disclosure controls and procedures.

Without admitting or denying the SEC's findings, the company agreed to a cease-and-desist order and to pay a $3 million civil penalty.

> "Issuers that choose to report non-GAAP financial metrics must accurately describe those metrics in their public disclosures."
>
> — Associate Director of the SEC's Division of Enforcement, Mark Cave

### SEC charges transportation company, former CEO for failing to disclose perks and payments

The SEC charged a freight transportation supply company and its former chief executive officer (CEO) and chairman for failing to disclose certain perquisites provided to the former CEO and other NEOs related to travel and security expenses incurred for the executives' spouses and certain related party transactions involving the former CEO.

The SEC's order alleged that the company had insufficient internal accounting controls, which resulted in a failure to record these expenses as perquisites as well as the amount of the related transaction with the former CEO. The SEC's order alleged the former CEO failed to provide required information to enable the company to identify the expenses as perquisites or provide necessary details related to personal transactions, resulting in material misstatements made by the company in SEC filings.

The SEC's orders alleged that the company and its founder and former CEO and chairman violated negligence-based antifraud and proxy provisions of the federal securities laws and committed or caused reporting, books and records, and internal accounting controls violations of the federal securities laws.

Without admitting or denying the SEC's findings, the company and the former executive agreed to cease and desist from future violations of the securities laws and to pay $1 million and $100,000 in civil penalties, respectively.

## SEC charges companies for unregistered offerings and sales of crypto asset securities

The SEC brought two separate actions alleging that companies had engaged in unregistered offerings and sales of securities to their investors through their respective crypto asset lending programs. The SEC's orders alleged the crypto asset lending programs, which collectively raised billions of dollars' worth of crypto assets from hundreds of thousands of investors, constituted an offer and sale of securities under applicable law and should have been registered with the Commission.

One of the companies agreed to a civil penalty of $22.5 million and to exit the US market to settle the SEC's charges, in addition to fines paid in actions brought by state authorities. The entities charged in the second matter are contesting the SEC's charges.