5 October 2023

SEC in Focus

Quarterly summary of current SEC activities

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SEC adopts new cybersecurity disclosure rules

The Securities and Exchange Commission (SEC or Commission) adopted final rules requiring registrants to disclose information about material cybersecurity incidents on Form 8-K within four business days of determining that an incident is material, with a delay only when the US Attorney General concludes that disclosure would pose a substantial risk to national security or public safety. The rules also require disclosures about cybersecurity risk management, strategy and governance in annual reports (e.g., Form 10-K, Form 20-F).

The SEC said the rules are intended to make sure that registrants disclose material cybersecurity information and provide investors with more consistent, comparable and decision-useful information. The rules apply to nearly all registrants that are required to file periodic reports with the SEC, including smaller reporting companies (SRCs) and foreign private issuers (FPIs), except for Canadian FPIs under the multijurisdictional disclosure system.

Registrants are required to disclose a material incident on Form 8-K and describe the material aspects of the nature, scope and timing of the incident and the material impact or reasonably likely material impact on the registrant's financial condition and results of operations. The rule requires the incident disclosures to primarily focus on the material impacts of the incident, rather than details about the incident itself.

The rules state that what constitutes materiality for purposes of determining whether an incident must be reported on Form 8-K is consistent with the Supreme Court's definition of materiality, and registrants need to thoroughly and objectively evaluate the total mix of information, taking into consideration all relevant facts and circumstances of the cybersecurity incident, including quantitative and qualitative factors.

The rules expand the definition of "cybersecurity incident" to include "a series of related unauthorized occurrences," reflecting the fact that cyber attacks sometimes occur over time. The rules say that the Form 8-K requirement could be triggered even if the material impact to the registrant is caused by a series of individually immaterial related cyber attacks.

The rules also require registrants to describe in their annual reports the processes they use, if any, to assess, identify and manage material cybersecurity risks, the board's oversight of such risks and management's role in assessing and managing such material risks (e.g., whether certain management positions or committees are responsible for assessing and managing cybersecurity risk and their relevant expertise), among other items.

Calendar-year registrants must provide the risk management, strategy and governance disclosures in their 2023 annual reports. All registrants other than SRCs must comply with the incident disclosure requirements beginning on 18 December 2023. SRCs must begin complying with Form 8-K disclosure requirements on 15 June 2024.

How we see it

When determining whether a cybersecurity incident is material, registrants should consider the nature of the data that may have been compromised when considering the effects of a cybersecurity incident on its financial condition and operations. For example, they should consider whether the incident involved information privacy, proprietary data loss, cyber extortion or data related to business interruption or network security, among other things.

Trends in 2023 SEC staff comment letters

Management's discussion and analysis (MD&A) and non-GAAP financial measures remained in the top two spots of our list of the most frequent topics in SEC staff comment letters for the year ended 30 June 2023. The volume of comment letters issued on periodic reports jumped nearly 60% from the previous year, mostly fueled by the SEC staff's continued focus on these two topics. Segment reporting and revenue recognition continue to be the two most frequent accounting topics resulting in staff comments.

Climate-related disclosures also continued to be one of the most frequent comment areas, with the number of registrants receiving a letter on this topic increasing by about 25% from the previous year. We expect the SEC staff to continue focusing on these disclosures in its reviews of year-end reporting, even as the SEC works to finalize new rules to require more extensive disclosures in the future. On average, staff comments on climate-related disclosures continued to require more rounds of comments to resolve than those on the other topics on our list.

We expect that the SEC staff will continue commenting on these topics and may expand its comments related to pay versus performance, cybersecurity, recovery of erroneously awarded compensation and other disclosures related to recently issued or amended SEC rules and financial accounting standards.

EY resources

- *Technical Line:* ***A Closer look at the SEC's new rules on cybersecurity disclosures***
- ***SEC Reporting Update: Highlights of trends in 2023 SEC staff comment letters***
- *Technical Line:* ***How to apply the SEC's new pay versus performance disclosure requirements***

Other SEC rulemaking updates

SEC staff publishes guidance on the pay versus performance rules

The SEC staff **published** new compliance and disclosure interpretations (C&DIs) on the pay versus performance (PvP) rules to clarify the following, among other things:

- For purposes of the PvP disclosures, market conditions should be considered in determining whether the vesting conditions of share-based awards have been met (i.e., registrants must include in executive compensation actually paid any change in fair value of awards subject to market conditions until the market conditions are satisfied).

- To calculate executive compensation actually paid, registrants may use a different valuation technique than the one they used to determine the grant date fair value of share-based payments in their US GAAP financial statements, if the other technique provides a better estimate of fair value after the grant date and is permitted under US GAAP.
- When calculating changes in the fair value of awards granted prior to an initial public offering (IPO), registrants should use the fair value of those awards as of the end of the prior fiscal year rather than other dates (e.g., the date of the IPO).
- If awards remain outstanding and have not vested because performance or market conditions were not met in an eligible year, but the awards can potentially vest in the future, registrants should not subtract the fair value of those awards when determining executive compensation actually paid.
- The fair value of awards must be computed using a methodology and assumptions permitted under Accounting Standards Codification (ASC) 718. For example, the expected term for options referred to as "plain vanilla" in Staff Accounting Bulletin (SAB) 14.D.2 should not be determined using the "simplified" method described in that SAB if those options do not meet the "plain vanilla" criteria at the remeasurement date, such as when the option is out of the money at the remeasurement date.

As a reminder, the PvP rules require disclosure of the relationship between executive compensation and financial performance for the five most recently completed fiscal years in proxy and information statements that are required to include executive compensation disclosures.

SEC staff issues guidance on insider trading plans and related disclosures

The SEC staff published C&DIs on the amended rules on insider trading plans under Rule 10b5-1 and related disclosures. The C&DIs clarify the scope of trading arrangements subject to certain disclosure rules, the requirements to disclose **trading plan terminations**, the trading **cooling-off period** imposed by the amendments and the availability of the Rule 10b5-1 affirmative defense to **certain 401(k) plan participants**, among other matters.

The SEC previously adopted amendments to Rule 10b5-1 under the Securities Exchange Act of 1934 and new disclosure requirements aimed at enhancing investor protections against insider trading and helping shareholders understand when and how insiders are trading in securities when they may have material nonpublic information.

SEC requires private fund advisers to disclose more to investors, restricts certain activities

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- *To the Point:* ***SEC requires private fund advisers to disclose more to investors and restricts certain activities***

The SEC **adopted** new rules under the Investment Advisers Act of 1940 that require SEC-registered private fund advisers to:

- Provide investors with quarterly statements with detailed information about private fund performance, fees and expenses
- Obtain an annual audit for each advised private fund and distribute audited financial statements to current investors within 120 days of each fund's fiscal year end
- Obtain a fairness or valuation opinion in connection with an adviser-led secondary transaction

The rules restrict certain activities and prohibit all private fund advisers from providing certain treatment deemed preferential, as well as other types of preferential treatment, unless it is disclosed to current and prospective investors and/or investor consent is received. The rules also require all registered advisers, including those that do not advise private funds, to document the annual review of their compliance policies and procedures in writing beginning 13 November 2023.

The rules do not apply to advised securitized asset funds, and the audit requirement does not apply to a special purpose vehicle unless the adviser treats it as a separate client.

Compliance with the quarterly statement and audit rules is required beginning 14 March 2025. Compliance with the other rules is required beginning 14 September 2024 for advisers with $1.5 billion or more in private funds assets under management and beginning 14 March 2025 for advisers with less than $1.5 billion in private funds assets.

SEC amends money market fund rules, Form PF reporting requirements for large liquidity fund advisers

The SEC **amended** certain rules that govern money market funds under the Investment Company Act of 1940. The amendments increase the daily and weekly minimum liquidity requirements to 25% and 50% of a fund's total assets, respectively, and remove provisions that permitted a money market fund to temporarily suspend redemptions and tied the imposition of liquidity fees to a fund's liquidity level.

The amendments require institutional prime and institutional tax-exempt money market funds to impose liquidity fees when they experience daily net redemptions that exceed 5% of net assets, unless the fund's liquidity costs are *de minimis*. They also allow retail and government money market funds to handle a negative interest rate environment by either converting to a floating share price or reducing the number of shares outstanding to maintain a stable net asset value per share. The amendments also require additional information about large private liquidity funds on Form PF.

The amendments are effective 2 October 2023, with a tiered transition period for compliance. The reporting form amendments are effective 11 June 2024.

SEC amends "names" rule for funds

The SEC **adopted** amendments to the "names" rule under the Investment Company Act of 1940 to expand the scope of funds that must adopt a policy to invest at least 80% of the value of their assets in accordance with the investment focus that the fund's name suggests. The amendments also update notice requirements and establish additional recordkeeping requirements, enhance prospectus disclosure requirements for terminology used in fund names and include additional requirements for funds to report information on Form N-PORT regarding compliance with the names-related regulatory requirement.

Compliance with the amendments is required 24 months after publication in the Federal Register for fund groups with net assets of $1 billion or more and 30 months after publication for fund groups with net assets of less than $1 billion.

SEC proposes rules for use of predictive data analytics by broker-dealers and investment advisers

The SEC **proposed** new rules and amendments to address conflicts of interest in the use of covered technologies, such as predictive data analytics, artificial intelligence and similar technologies, by broker-dealers and investment advisers (collectively, firms) in investor interactions.

The proposal would primarily require firms to eliminate or neutralize conflicts of interest associated with their use of covered technologies in investor interactions. Firms that have any investor interaction using covered technology would be required to have written policies and procedures reasonably designed to prevent violations of (in the case of investment advisers) or achieve compliance with (in the case of broker-dealers) the proposed rules.

SEC proposes internet adviser registration reforms

The SEC **proposed** amending the internet adviser exemption from the prohibition on SEC registration for smaller investment advisers by requiring an investment adviser relying on the exemption to have at all times an operational interactive website through which the adviser provides investment advisory services on an ongoing basis to more than one client.

The proposed amendments would also eliminate the current rule's *de minimis* exception for non-internet clients, thus requiring the adviser to give advice to all its clients exclusively through an operational interactive website.

Other SEC matters

Sample comment letter on XBRL disclosures

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 registrants on eXtensible Business Reporting Language (XBRL) and Inline XBRL disclosures. The SEC staff said it may also comment on matters other than those in the sample comment letter, depending on the type of filing under review and the facts and circumstances.

Highlights from the September 2023 SEC Investor Advisory Committee meeting

The SEC Investor Advisory Committee (IAC) recommended that the Commission strengthen existing human capital disclosure rules. The IAC recommendation noted that the SEC's current rules on human capital and the Financial Accounting Standards Board's proposal to require disaggregation of certain income statement expenses, fall short of providing investors with sufficient and comparable information needed for the accurate valuation of human capital.

The IAC recommended that the Commission propose requiring the following disclosures in its upcoming human capital disclosure proposal:

- The number of people employed by the issuer broken down by full-time, part-time or contingent workers
- Turnover or comparable workforce stability metrics
- The total cost of the issuer's workforce, broken down into major components of compensation (e.g.., wages, benefits, stock compensation, training)
- Workforce demographic data sufficient to allow investors to understand the company's efforts to access and develop new sources of talent, and to evaluate the effectiveness of these efforts
- Narrative disclosure in the MD&A of how the issuer's labor practices, compensation incentives and staffing fit within its broader strategy

Additionally, the IAC recommended that human capital quantitative disclosures be subject to reasonable assurance.

SEC appoints George Botic to PCAOB Board

The SEC appointed George R. Botic as a board member of the Public Company Accounting Oversight Board (PCAOB or Board). Botic, who currently serves as the PCAOB's Director of the Division of Registration and Inspections, will replace Board Member Duane M. DesParte, whose second term ends 24 October 2023.

Enforcement activities

SEC charges company with failure to disclose related person transaction

The SEC charged a transportation service provider for failure to disclose a related person transaction. According to the SEC's order, the company failed to disclose a company board director's role in a large shareholder's sale of about $424 million in private shares before the company's initial public offering. The director received millions of dollars in compensation from his role in structuring and negotiating the deal.

> "We remain vigilant in ensuring investors are not deprived of critical information about transactions occurring close to a company's initial public offering.
>
> — Sheldon L. Pollock, Associate Regional Director of SEC's Division of Enforcement

Without admitting or denying the SEC's findings, the company agreed to a cease-and-desist order and to pay a $10 million civil penalty.

SEC charges company with failure to maintain sufficient internal controls

The SEC charged a global engineering, procurement and construction company for failure to sufficiently maintain internal controls to account for two construction projects in accordance with the percentage of completion accounting method under US GAAP. Five former and current officers and employees were also charged for causing the company's violations.

The SEC's order alleges that the company failed to include all anticipated costs and improperly incorporated revenue from unapproved change orders into the forecasts of certain projects. These failings allegedly resulted in inaccurate books and records and, ultimately, in materially misstated financial statements included in periodic reports filed with the SEC.

Without admitting or denying the SEC's findings, the company consented to cease and desist from committing or causing future violations and to pay a $14.5 million civil penalty. The former and current officers and employees, without admitting or denying the SEC's findings, consented to cease and desist from committing or causing the relevant violations and to pay penalties ranging from $15,000 to $25,000.

Manufacturer charged with failure to account for and disclose warranty liability

The SEC charged a window manufacturer for failure to recognize and disclose a warranty liability to address a defect in its windows in accordance with US GAAP. The company identified the error and restated its financial statements to correct the error in accounting for the liability following an internal investigation.

Without admitting or denying the SEC's findings, the company agreed to cease and desist from future violations. In agreeing to settle with the company and forgo a civil penalty, the SEC considered the company's timely self-reporting, significant cooperation and remediation.

The SEC also filed a complaint in a U.S. district court charging a former executive with violating negligence-based antifraud, proxy disclosure, and books and records provisions of the federal securities laws. The SEC seeks permanent injunctions, civil penalties, and an officer and director bar.

SEC charges company with accounting and internal controls violations

The SEC charged a provider of hydrogen fuel cell systems for financial reporting, accounting and internal control failures. The SEC's order alleged that the company improperly accounted for certain sale-leaseback transactions, research and development costs, and loss accruals.

The company restated multiple years of financial statements to correct the errors and disclosed a material weakness in internal controls over financial reporting (ICFR). Subsequent to the restatement, the company also disclosed that certain material weaknesses were remediated. However, the SEC's order alleged that the material weaknesses had not been fully remediated.

Without admitting or denying the findings, the company consented to the SEC's order and agreed to pay a civil penalty of $1.25 million and to implement undertakings, including a requirement to fully remediate the material weakness in ICFR and ineffective disclosure controls and procedures within one year of the SEC's order. If the company fails to satisfy the undertakings, it is ordered to pay an additional civil penalty of $5 million.

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SCORE No. 21164-231US

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