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The SEC Is Open for Business: Takeaways from the AICPA's 2017 Conference on Current PCAOB and SEC Developments

One of the key messages conveyed by the Staff (the "Staff") of the SEC's Division of Corporation Finance (the "Division") at the annual gathering in Washington, D.C. for the AICPA's 2017 Conference on Current PCAOB and SEC Developments is that the Staff is committed to working with registrants and their advisers in a collaborative fashion. The theme was prominent in a number of presentations and comments from Chair Jay Clayton's keynote presentation to various presentations by panelists representing a range of SEC functions. A related message conveyed by the Staff is that the Division is endeavoring, wherever possible, to act based on delegated authority ahead of formal rulemaking. To a large extent, the messages seem to have been informed by the decline over the past 10 years in the number of listed companies, and the decline in recent years in the number of companies going public, in the United States. As noted in other contexts over the past few months, the Staff believes that more can be done from a rulemaking perspective to increase the number of companies (both domestic and foreign) that access the U.S. public markets.

Set forth below are some of the more salient takeaways from Staff comments at the conference, which as is customary were preceded by the disclaimer that the views expressed are personal to the speaker:

Disclosure Effectiveness

Not surprisingly, given the number of recent SEC releases (which incidentally also pre-date Chair Clayton's arrival at the SEC) that focused on modification of disclosure requirements, the Staff indicated that what started out as a focus on disclosure effectiveness and migrated to disclosure modernization and simplification following Congressional action as part of the FAST Act is very much a work-in-progress. The Staff is mindful of the burden, particularly on smaller registrants, of current disclosure requirements and is considering modifications that would provide for far more scalable disclosure and related requirements.

Waivers under Regulation S-X Rule 3-13

The Staff noted that the rulemaking process can be a cumbersome one, with efforts taking over a year to come to fruition. In the interim, the Staff has delegated authority under Rule 3-13 to waive financial statement form and content requirements or permit filing, in substitution of the normally required financial statements, of appropriate financial statements of comparable character, provided the action is consistent with investor protection. The Staff has been exercising that authority with increasing

frequency and urged registrants to make greater use of this waiver procedure. To a certain extent, the Rule 3-13 procedures appear to have offset the imperative to formally amend financial statement requirements.

The Staff reminded registrants that calling the number set forth in the Financial Reporting Manual (“FRM”) (+1 (202) 551-3111) is appropriate for the more straightforward inquiries. For anything more complex, registrants are encouraged to email their questions/requests (dcaoleters@sec.gov) so as to shorten the overall response time. The example was given of having a Staff member return a call, only to have 11 people on the phone; that, in the Staff’s view, is counterproductive. If a broader discussion is appropriate, the Staff will want sufficient time to arrange for the appropriate members of the Staff from different disciplines to be briefed and available to participate in that discussion. The Staff also noted that having the auditors call separately from counsel is also counterproductive. Emailed requests should be concise. If the working group is unsure which approach to follow, call first to see if a written request makes more sense.

The Staff also reminded registrants that the Division will consider questions on a case-by-case basis and that registrants should not assume that relief granted to one registrant will be granted to other registrants, or that the failure to grant relief in one instance will be followed in other cases in the future.

Regulation S-X Rules 3-05/3-09/3-10 and Article 11

There appears to be a general recognition on the part of the Staff that financial statement requirements for acquired companies (under Rule 3-05), equity method investees (under Rule 3-09) and guarantors (under Rule 3-10) are cumbersome and the burden of preparing/presenting required financial statements may outweigh the benefit to investors. The Staff noted that Rule 3-10 disclosures have had the unintended effect of pushing deals into the “144A-for-life” market to avoid some of the complexities inherent in providing guarantor financial information under Rule 3-10.

One area of flexibility is in the application of the significance tests for purposes of determining whether acquired business financial statements are required and whether pro forma financial information (under Article 11) needs to be provided to reflect the acquisition of such businesses. The Staff indicated that the Division may well look to other indicators such as revenue, operating income or other operating metrics if application of the significance tests (assets, pre-tax income or investments) would lead to an anomalous result (*i.e.*, require target financial statements and pro forma financial information for a target that as a practical matter is not material to the registrant). The Staff may conclude, on the basis of a less mechanical approach, that the Division will not object to the omission of financial statements for acquired businesses and the related pro forma information and may also permit the omission of pre-acquisition financial statements that otherwise would be required under the major significance rules (above 70% or 80%). This flexibility is a clear departure from the Staff’s past practice.

The Staff also appeared to be willing to be more flexible when it comes to financial statement requirements applicable to domestic registrants acquiring foreign businesses reporting under International Financial Reporting Standards.

The Staff indicated that the Division will entertain waiver requests in respect of Rule 3-09 requirements before the end of the relevant fiscal year, and will entertain waiver requests in respect of Rule 3-05 requirements prior to the announcement or consummation of an acquisition.

The Staff implied that potential modifications ultimately could include changes to the number of years for which financial statements need to be provided under Rule 3-05, changes to the percentages used to determine significance and more useful guidance in respect of pro forma adjustments. As to the latter, the Staff conceded that the little guidance provided (*i.e.*, that adjustments must be directly attributable, factually supportable and, in the case of income statement data, expected to have a continuing impact) as to what can/cannot be reflected as a pro forma adjustment is not that helpful.

Omitted Information

For purposes of the guidance that eliminates the need to include in confidentially submitted draft registration statements interim financial statements that a registrant reasonably believes will not be required at the time it launches its offering, the Staff confirmed that information required under Item 8.A.5 of Form 20-F that constitutes more recent publicly available information can be omitted if such information will be superseded at launch.

Financial Reporting Manual

Changes to the FRM can also be expected. The Staff noted that the FRM has evolved over the years, essentially by the addition of new guidance, without much thought being given to historical positions that may no longer be appropriate in today's markets. The Staff characterized the effort as a wholesale clean-up of the FRM to reflect the "reality of today," which should be completed over the next year or two.

Two-Way Communications

The Staff reiterated that the Division endeavors to respond to registrants as quickly as possible and has reduced response times significantly. For routine Rule 3-05 questions, the Staff indicated that the Division targets responding within 10 business days and is responding to over half the inquiries within five business days. The Staff encouraged registrants to call if they do not hear back from the Staff within 10 business days.

Similarly in the context of comment letters, the Staff encouraged registrants to contact Staff members identified in a letter if the substance of the comment is unclear or if a registrant believes it is necessary to provide context for a response that ultimately will be reflected in the written response.

In response to a question, one Staff member noted that face-to-face meetings are not encouraged, though the one exception may be in connection with initial public offerings where there are significant interpretive issues, for example, around financial statements of businesses being rolled into the issuer.

Non-GAAP Financial Measures

With respect to non-GAAP financial measures, while the number of Staff comments spiked following the release of the May 2016 C&DIs, the number appears to have now levelled off. The Staff stated that the Division is pleased with the general response to the updated guidance, though members of the Staff acknowledged that they continue to monitor compliance with all Staff guidance and expect they will continue to issue non-GAAP financial measure comments. The Staff also noted that, as with other disclosure topics, registrants should avail themselves of the opportunity to discuss interpretive questions with the Staff.

The Staff reminded issuers that, in the mergers and acquisitions context, the Staff had concluded that figures provided as part of the fairness opinion process that ultimately need to be included in a proxy statement or registration statement would not be treated as non-GAAP financial measures by reason of the fact that such figures typically are being provided in response to case law addressing fiduciary duties of directors in bid situations.

Cyber

The Staff indicated that, with respect to cyber-related issues, instead of issuing additional division-level guidance on disclosure obligations in respect of cyber-attacks, the Division is now considering commission-level guidance. One area of focus is how cyber risks are being integrated into internal control over financial reporting and disclosure controls and procedures. New guidance may address the topic of escalation of cyber matters beyond the purview of IT staff. The Staff is mindful of the need for registrants to avoid providing roadmaps for future attacks and is equally mindful of the fact that companies may well learn more in the days immediately following an attack. The Staff cited the value of postmortems that will benefit the broader industry. The Staff also singled out insider trading ahead of the release of information about a cyber-attack as an area of concern, and underscored the need for information about any such attack to be escalated to the relevant point persons under applicable disclosure controls and procedures and securities trading clearance procedures.

Cross-Border Acquisitions

The Staff noted that the Division is considering whether changes are warranted to the definition of “foreign business” (in Rule 1-02(1)) and the related rules for foreign incorporated targets or investees that do not qualify as foreign businesses for purposes of the financial statement requirements of Rules 3-05 and 3-09. See Sections 6350.3 and 6410.9 of the FRM. Issues can arise particularly as a result of the limitations on U.S. ownership (see Section 6110.4 of the FRM).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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